



MERGERS AND ACQUISITIONS

Czech Republic

Taxation of Cross-Border Mergers & Acquisitions
2008 Edition

TAX

Czech Republic

Introduction

Czech law contains a variety of special provisions applying to mergers and acquisitions in areas such as company law, competition, environmental protection, accounting, and tax. Unlike many jurisdictions, however, the Czech Republic did not have detailed tax legislation dealing with mergers and acquisitions before European Union accession (1 May 2004), when legislation enacting the EU Mergers 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 should 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 effect the acquisition. Further reorganizations may be necessary after the acquisition to help maximize tax deductions.

The form chosen for an acquisition will determine its tax consequences to some extent, 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.

Structuring the Transaction

Company Law: Choice of Entity

As indicated above, the purchaser may establish a new entity to make the acquisition, or may purchase an interest in an existing entity. Czech company law provides for the following legal entities that are generally used for business activity.

Limited Liability Company (společnost s ručením omezeným – s.r.o. or spol. s r.o.)

- Corporation, usually closely held; relatively simple to form.
- Earnings taxed once at the corporate level (2007: 24 percent, 2008: 21 percent, 2009: 20 percent, 2010: 19 percent).

- Distributions subject to withholding tax (2007, 2008: 15 percent; 2009: 12.5 percent in most cases, 15 percent for dividends and interest paid abroad).
- Reduction of withholding tax on distributions under double tax treaties, and exemption from tax for distributions received from Czech or EU resident companies in which the payer has had at least a 10 percent interest for 12 months. From 1 January 2008, the exemption was extended to dividends received by a Czech resident company or a Czech permanent establishment of an EU resident company from subsidiaries in non-EU countries that have entered into double taxation treaties with the Czech Republic. Several conditions have to be met, including a requirement that a subsidiary is subject to corporate income tax of at least 12 percent. From 2008, gains on the sale of significant shareholdings (more than 10 percent) which have been held for at least 12 months are no longer subject to tax for Czech companies or certain permanent establishments of foreign persons. Qualifying holdings will be defined in the same way as for the dividend distribution exemption.
- No tax consolidation.

Joint-Stock Company (akciová společnost – a.s.)

- Corporation, usually used for publicly-owned companies and capital-intensive operations.
- Earnings taxed once at the corporate level (2007: 24 percent, 2008: 21 percent, 2009: 20 percent, 2010: 19 percent).
- Distributions subject to withholding tax (2007, 2008: 15.0 percent; 2009: 12.5 percent, in most cases, 15 percent for dividends and interest paid abroad).
- Reduction of withholding tax on distributions under double taxation treaties, and exemption from tax for distributions received from Czech or EU resident companies in which the payer has had at least a 10 percent interest for 12 months. From 1 January 2008, the exemption was extended to dividends received by a Czech

Czech Republic

resident company or a Czech permanent establishment of an EU resident company from subsidiaries in non-EU countries that have entered into double tax treaties with the Czech Republic. Several conditions have to be met, including a requirement that a subsidiary is subject to corporate income tax of at least 12 percent. From 2008, gains on the sale of significant shareholdings (more than 10 percent) which have been held for at least 12 months are no longer subject to tax for Czech companies or certain permanent establishments of foreign persons. Qualifying holdings will be defined in the same way as for the dividend distribution exemption.

- No tax consolidation.

European Company (Societas Europaea – SE)

- Corporation introduced under the EU Regulation 2157/2001 on European Companies; has exactly the same legal and tax status as a joint-stock company.
- SEs are not frequently established, but have been used several times for tax optimization.

General Commercial Partnership (veřejná obchodní společnost – v.o.s.)

- Partnership (legal entity); all partners must have unlimited liability.
- Not taxed at the entity level, except for income subject to withholding tax as a final tax (such as dividends from Czech companies).
- Partners taxed on their share of taxable profits (excluding income subject to withholding tax as a final tax) whether distributed or not.
- Under domestic law, non-resident partners' shares of profits are regarded as permanent establishment income, which may be subject to prepayment of tax liability by withholding of tax from distributions.

Limited Partnership (komanditní společnost – k.s.)

- Partnership (legal entity); at least one partner must have unlimited liability; the other(s) may have limited liability.
- Unlimited liability partner share not taxed at the entity level (same as general commercial partnership).

- Limited liability partner share taxed at the entity level as if it were a corporation.
- Unlimited liability partner(s) taxed on their share of taxable profits (excluding income subject to withholding tax as a final tax), whether distributed or not.
- Non-resident unlimited liability partner(s) taxed in the same way as in a general commercial partnership.
- Distributions to limited liability partners taxed as distributions of profit by a company – 15 percent withholding tax subject to tax treaties; EU Parent/Subsidiary Directive does not apply to a limited partnership.

Tax-Free Corporate Reorganizations

As indicated above, there are no comprehensive tax rules on corporate reorganizations. The rules that exist (the enactment of the EU Merger Directive) 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. 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. 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 (that do not amount to an enterprise) to a person not registered for value-added tax (VAT) is regarded as a taxable supply for VAT purposes, but the law is silent on the status of a contribution to a registered VAT payer. It is generally considered that contributions to VAT registered entities are, therefore, outside the scope of VAT, but the legislation in this area is likely to change in the medium term. With regard to the contributed assets, the conditions for the input VAT deduction should be considered.

A contribution of an enterprise or part of an enterprise is not a taxable supply. No VAT claw back arises from input VAT previously claimed on the contributed assets.

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 (the 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 shares received have a value equal to the book value of the company dissolved;
- tax depreciation of the dissolved company is 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 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. Previously a cross-border merger was only possible if an SE was being created, but from 15 December 2007, it should have been possible to merge a Czech company with any company registered in an EU Member State. However, the Czech Republic failed to amend the legislation and it is currently expected that the amendment of the Czech law enabling such mergers will be adopted in the first half of 2008.

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 register.

There are no real estate transfer tax, VAT, or stamp/capital duties.

Czech Republic

De-Merger

Under the commercial code, 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 Income Tax Act 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.

Spin-Off

A spin-off is an alternative de-merger permitted since March 2006. 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.

Asset Deal

The main tax effect of an asset deal is that the buyer has full tax basis in the assets acquired and the seller will be 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); and
- 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.

Buyer

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. 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 individual assets in such a valuation is treated as goodwill, which can be depreciated for tax purposes over 15 years. When no valuation is carried out, any difference is 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 apply also to negative goodwill; that is, the situation where the price of the whole or part of an enterprise is lower than the value of the assets. Such cases are comparatively common in the Czech Republic, possibly because assets were originally overvalued 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.

Seller

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 normal income tax rates. In both cases, any sale of real estate will also be subject to 3 percent real estate transfer tax. A sale of assets is usually a taxable supply for VAT purposes, although some components are exempt from VAT or outside its scope. The sale of an enterprise is not a supply for VAT purposes, but the seller remains entitled to credit for any related input VAT.

Share Deal

Buyer

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 tax liabilities of the target company.

Seller

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 as normal income. From 1 January 2008, however, gains on the sale of shares in a subsidiary (10 percent holding for at least 12 months) became tax exempt for a Czech company or a Czech permanent establishment of a company located in an EU Member State or a country

with which the Czech Republic has concluded a double tax treaty. Losses on disposal are not deductible, except in the case of shares in an a.s. or SE which are held for trading purposes. In the case of an individual who does not record the investment as an asset in the accounts of a business that he/she operates personally, 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. From 1 January 2008 the six-month test applies only to publicly tradable securities (maximum shareholding of 5 percent); for the other shares the minimum holding period is five years. A gain on the sale of an interest in an s.r.o. is exempt from tax if it has been held for more than five years.

Documentation

Detailed documentation of transactions is recommended. The tax authorities generally give far more weight to the form of a transaction than to its substance. In addition, even small errors or discrepancies may result in a refusal by the commercial courts to register a transaction, with the result that the transaction is invalid or the process has to be started again. In particular, as indicated above, it is important to ensure in relevant cases that the allocation of the purchase price to individual assets is sufficiently demonstrated and that all steps are taken to establish whether a transaction is a sale of an enterprise or of individual assets.

Funding

Deductibility of Interest Payments

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 within the six months

preceding the acquisition of a subsidiary 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 the subsidiary for at least 12 months.

A merger of the holding company with the target can mitigate the last two concerns described above. 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.

Interest on debts incurred for the purposes of the purchase of business assets would normally be tax deductible.

The Czech Republic levies withholding tax of 15 percent on interest payable to non-resident lenders. This is reduced by double-taxation agreements, normally, but not invariably, to 0 percent. Since 1 May 2004, 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 that the recipient is the beneficial owner of the interest.

Thin-Capitalization

Up to the end of 2007 interest was not deductible to the extent that it related to borrowings from related persons and the ratio of debt from such persons to equity was greater than four-to-one (six-to-one in the case of banks and insurance companies). The term related persons is broadly defined as:

- entities having an interest of at least 25 percent in the borrower;
- entities in which the borrower has an interest of at least 25 percent;
- entities in which the same person has an interest of at least 25 percent; or
- persons otherwise controlling the borrower or controlled by the borrower.

Until 1 January 2005, these rules were confined to loans from persons who participated directly or

Czech Republic

indirectly in the management, control, or capital of the recipient. Participation in control or capital is defined as having a share greater than 25 percent in the borrower's registered capital or voting rights. Participation in the management is not defined. These rules still apply to loans entered into up to 1 December 2003. The broader definition of related persons (see above) applies from 1 January 2005.

From 1 January 2008, new thin-capitalization rules apply. All financial expenses should be tested under these new rules, which cover interest and related costs, such as expenses on guarantees or fees for processing the loan. Financial expenses are non-deductible if:

- they exceed the limit calculated as follows: the average amount of debts drawn during the taxable period multiplied by the 12-month inter-bank deposit rate increased by 400 bps (different rates for different currencies);
- they are incurred on subordinated debt (defined for purposes of the Bankruptcy Act);
- the interest amount or the maturity of interest is dependent on the borrower's profit;
- debts from both related and unrelated parties drawn during the tax period exceed six times (four times from 2009) the borrower's equity;
- debts granted or secured by related parties exceed two times the borrower's equity (three times if the borrower is a bank or an insurance company); or
- equity is not defined, but according to the Finance Ministry's interpretation it means registered capital plus reserves.

Until 2010 the new rules will not apply to loans concluded before 1 January 2008 as long as the principle and interest rate remain unchanged.

Other Considerations

Pre-Acquisition Losses

When the ownership of more than 25 percent of the registered capital or voting rights changes, or a member of the company acquires a controlling interest (greater than 50 percent), and less than 80 percent of the company's income in the period following the change in ownership is derived from the same activity as in the period in which the loss arose (source of income test), no tax losses carried forward can be used after the change of ownership.

When the company is an a.s. that has issued bearer shares, the ownership of which cannot easily be tracked, there will always be deemed to be a change in ownership if the source of income test described in the preceding paragraph is not met.

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.

It is possible to obtain certification from the tax authority that the source of income test has been met. However, this is available only after the end of the accounting period in which it is sought to use the losses.

Tax Consolidation

There is no tax consolidation under the Income Tax Act. This means that the use of a highly leveraged Czech holding company to acquire a target is ineffective, unless followed by a merger.

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 a tax liability of the seller initially, but the liability passes to the buyer if the seller defaults.

Value-Added Tax (VAT)

The Czech Republic levies VAT at rates of 9 percent from 2008 and 19 percent. Most goods and services are subject to the 19 percent rate. Transfers of shares are exempt. As described above, the sale of an enterprise is outside the scope of VAT, with credit for related input tax. 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 assets concerned.

Due Diligence Reviews

Due diligence reviews are accepted as normal procedure in the case of acquisitions of companies, whose tax liabilities will pass with the ownership of the company.

They normally cover:

- Adequacy of tax provisions
- Identification of years potentially open to tax inspections
- Analysis of issues raised in tax inspections
- Analysis of differences between accounting and tax profits
- Analysis of tax losses
- Compliance with indirect tax and employee tax and social security reporting
- Identification and analysis of potentially controversial issues

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 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.
- 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 possible.

Czech Republic

KPMG in Czech Republic

Eva Doyle
KPMG Česká republika, s.r.o.
Pobřežní 648/1a
Prague
186 00
Czech Republic

Tel. +420 222 123 564
Fax +420 222 123 446
e-Mail: edoyle2@kpmg.cz

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2008 KPMG Česká republika, s.r.o., a Czech Republic limited liability company and a member firm of the KPMG network of independent member firms affiliated with KPMG International, a Swiss cooperative. All rights reserved.