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NEWS No. 2/2008

THIN CAPITALISATION RULES

I. Introduction

Since 1 January 2008 two different thin capitalisation rules have been simultaneously in force in the Czech Republic. The effect of the respective amendments depends on the date of signing the credit or loan agreements in question:

1. Before 31 December 2007 ("old regulation")
2. After 1 January 2008 ("new regulation")

The following regulations are applicable to the respective agreements:

Agreement signed \ Period	Before 31 December 2007	2008-2009	2010
before 31 December 2007	old regulation	old regulation unless an amendment has been signed	new regulation
after 1 January 2008	-	new regulation	new regulation

II. General Aspects

In the past, thin capitalisation was examined only where related parties were concerned.

Czech tax law defines two categories of related parties:

Capital-related parties	Direct interest of at least 25% in the equity capital or in the voting rights
	Indirect interest of at least 25% in the equity capital or in the voting rights
Otherwise related parties	Management or control activity of one party or related parties in several entities
	Controlling and controlled entity
	Entities controlled by the same entity
	Relatives
	Parties with a legal relationship on the grounds of a tax basis reduction or a tax loss increase

As of 1 January 2008 thin capitalisation rules have been introduced for all loans irrespective of the creditor.

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III. Old Regulation

a) Loan Amount

The interest expenses of loans and credits from related parties are considered tax ineffective where the loan amount exceeds more than four times (for banks and insurance companies more than six times) the equity capital.

b) Interest Rate

The interest rate must be defined in accordance with the "Arm's Length Principle". Should the interest expenses be tax effective, the interest rate applicable to loans and credits between affiliated entities amounted to 140% of the discount rate of the Czech National Bank (ČNB), valid as of the date of signing the credit or loan agreement.

IV. New regulation since 1 January 2008

Until 2010, the current regulation will be applicable to agreements signed before 31 December 2007. In the event of agreements signed in 2008, all financial interest costs related to the credits and loans must be examined as follows.

b) Financial Costs

Financial costs related to credits and loans are not tax deductible where their amount depends on the economic result of the debtor or where subordinated to other commitments of the debtor (i.e. to be settled after all other commitments in a bankruptcy or liquidation proceedings).

For all loans and credits, the amount of the tax effective financial costs may not exceed the arithmetic product of the average loan portfolio during one year and the uniform interest rate. The uniform interest rate is calculated as the sum of the arithmetic average of the 12M benchmark interest rates defined for the respective currency as of the last days of the respective months and additional interest amounting to 4 percentage points. The benchmark interest rates must be defined for every credit or loan according to the respective currency. 12M PRIBOR applies to CZK.

Where the amount of the financial costs for credits and loans from non-related parties does not exceed CZK 1 million per year, all financial costs are tax deductible.

b) Loan Amount

The financial costs for loans and credits from related parties are considered tax ineffective where the loan amount exceeds more than twice (for banks and insurance companies more than three times) the equity capital. The financial costs for loans and credits from non-related parties are considered tax ineffective where the loan amount exceeds more than six times (starting 1 January, 2009 more than four times) the equity capital. Interest-free loans and credits are not taken into account when calculating the amount of the loans and credits provided.

c) Interest Rate

In the future, the interest rate must be also defined in accordance with the "Arm's Length Principle". However, the new regulation does not stipulate that the interest rate between related parties must amount to 140% of the discount rate of the Czech National Bank (ČNB); reasonable interest rate may not exceed 4 percentage points above PRIBOR.

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V. Summary of the Applicable Regulations

a) Applicability of the regulations in time

i) Affiliated entities:

	Interest rate / financial costs	Undercapitalisation
Before 31 December 2007	1.4-times the discount rate of the Czech National Bank	four-times the equity capital
Before 31 December 2007	12M PRIBOR + 4% p.a. (new loans and credits)	two-times the equity capital (new loans and credits)
From 1 January2010	12M PRIBOR + 4% p.a. (all loans and credits)	two-times the equity capital (all loans and credits)

ii) Non-affiliated entities:

	úroky / finanční náklady	nízká kapitalizace
Before 31 December 2007	Not regulated	Not regulated
Before 31 December 2008	12M PRIBOR + 4% p.a. (new loans and credits)	6-times the equity capital (new loans and credits)
Before 31 December 2009	2M PRIBOR + 4% p.a. (new loans and credits)	4-times the equity capital (new loans and credits)
From 1 January 2010	12M PRIBOR + 4% p.a. (all loans and credits)	4-times the equity capital (all loans and credits)

b) Procedure when Assessing Tax Deductible Financial Costs

The following procedure is recommended to assess the tax effectiveness and to exclude non-deductible financial costs:

1.	Financial costs of subordinated credits and loans Interest costs of credits and loans depending on the economic result of the debtor	to be excluded
2.	Financial costs of the part of credits and loans of affiliated entities exceeding more than twice the equity capital	to be excluded
3.	Financial costs of the part of credits and loans of non-affiliated entities exceeding more than six times (or four times) the equity capital	to be excluded
4.	Financial costs exceeding the arithmetic product of the average loan portfolio during one year and the uniform interest rate raised by 4 percentage points	to examine whether the percentage of the financial costs has been excluded within steps 1-3; the remaining part to be excluded

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VI. Expected Future Development

At present, the Ministry of Finance is drafting an amendment to the Income Tax Law to reduce the above-mentioned impacts.

The obligation to apply the thin capitalisation rules to loans and credits from foreign non-related parties is expected to be cancelled (with retrospective effect as of 1 January 2008). The rule to calculate the tax applicable interest using "12M PRIBOR + 4% p.a." is expected to be cancelled.

Pursuant to S. 24(2)(zc), the costs defined as non-deductible in S. 25 are also tax deductible, namely up to the amount of the revenues received. Under the applicable regulation, this exception does not apply to financial costs exempted in accordance with the thin capitalisation rules. The amendment is also expected to re-introduce this exception for financial costs.

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