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Amendment to the Income Ta x Act and Other Acts

The Public Budget Stabilization Act

On 21st August 2007, the Chamber of Deputies passed the Public Budget Stabilization Act, which includes, among others, an amendment to the Income Tax Act. The Act has been approved by the Senate. When it is signed by the President it will come into effect on 1st January 2008. Major amendments are to be made in following areas:

Personal Income Tax

- The rate of personal income tax will amount to 15 % for 2008 and decrease to 12.5 % from 1st January 2009.
- Super-gross wage – the tax base for calculating the tax on income from employment will include social and health insurance contributions, which are to be obligatorily paid by the employer, and the tax base will not be reduced by insurance contributions which are to be obligatorily paid by the employee.
- Tax credits – from 1st January 2008 the annual personal allowance will amount to CZK 24,840, a year later it will drop to CZK 16,560. The same amount can be deducted also for a spouse with no income. The tax bonus for a child will reach CZK 10,680 next year, and CZK 10,200 in 2009. The tax bonus for a child who is studying will be equal in both following years – CZK 4,020.
- Lump-sum expenses for the determination of the tax base and for calculating the tax on individual income from trades and other self-employment will not be changed. However, there will be a supplement if a taxpayer deducts any percent of expenses from his/her income, such expenses will constitute total expenses. It means that, similarly as with the income from employment, deduction of paid contributions for social security and public health insurance will not be possible.
- Joint taxation of spouses will be abolished due to the flat tax scheme.
- The minimum tax base that currently applies to the calculation of tax on income from trades and other self-employment will also be eliminated.
- Exemption from tax on gains from the sale of securities under the condition of holding the securities for at least for 6 months will in the future apply only to gains from investment securities and collective investment securities, only if the seller had no interest (direct or indirect) in registered capital and no share in voting rights exceeding 5% in the period of 24 months prior to the sale. Gains from the sale of other securities will be exempt from tax only if the period between the sale and the acquisition of securities has exceeded 5 years. Under transitional provisions, securities acquired until the end of 2007 will not be affected by the amendment.
- Contributions from the employer to a supplementary pension scheme with state contributions and personal life assurance contributions up to CZK 24,000 per annum made by the same employer will be tax exempt.
- Temporary accommodation provided by the employer through a non-monetary form only up to CZK 3,500 monthly will be exempt from tax.

Corporate Income Tax

- From 1st January 2008, the tax rate will amount to 21%. The tax rate will be reduced to 20% one year later and to 19 % in the beginning of 2010.
- The rules of what is known as thin capitalization, i.e. allowability of interest on credits and loans for tax purposes will be tightened. Thin capitalization will also apply, in addition to interest, to related expenses including expenses incurred in relation to security, processing of credits, fees for pledges and mortgages (hereinafter referred to as "financial expenses"), also in connection with credits and loans from unrelated parties. Financial expenses will be non-deductible for corporate tax purposes if:
- financial expenses in total exceed during the tax period the amount calculated as a multiple of the uniform interest rate1 increased by four percentage points and the average balance of credits and loans during the tax period;

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- financial expenses arise from credits and loans, which are subordinated to other debts of the taxpayer;
- financial expenses arise from credits and loans where the interest or profit or their maturity are completely or partially derived from the taxpayer's profits;
- the total number of credits and loans during the tax period or during the period for which the tax return is submitted exceeds six times the amount of the owned capital (four times from 2009);
- the total number of credits and loans provided by related parties or secured by related parties exceeds two times the amount of the owned capital during the tax period (three times for banks and insurance companies).

Each of the thin capitalization conditions is considered individually. The rule of thin capitalization will not apply to financial expenses charged from unrelated parties not exceeding CZK 1 million during the tax period.

Under the transitional provision, the new rules will apply for the first time to financial expenses incurred in respect to contracts concluded after 1st January 2008 and incurred in respect to annexes to contracts, changing the amount of loans, credits and interest, concluded after 1st January 2008. From 1st January 2010, the new rules will apply to all loans and credits regardless the date of the contract or annex.

Uniform interest rate is determined as an average of benchmark value of interest rates in the market of interbank deposits for maturity of 12 months relevant for the currency in which the credit or loan is denominated, as of the last day of each month of the tax period, or the period for which the tax return is submitted. Interests on credits and loans denominated in different currencies are assessed separately with respect of individual currencies.

We recommend that all companies analyze the financing structure of their activities to identify in time whether it will be necessary to change the financing structure to prevent possible non-allowability of the interest on financing for tax purposes.

- Earnings from dividends paid by entities from third countries (i.e. countries outside the Europe Union) will be under certain conditions exempt from corporate tax. The payer of the dividends must be a tax resident of a country with which the Czech Republic has concluded a double taxation avoidance treaty and must be subject to taxation similar to the Czech income tax with a rate exceeding 12 %. The entity paying dividends must have a legal form similar to the Czech limited liability company, joint-stock company or co-operative and must have a similar relationship to the dividend payee like a subsidiary has to its parent company (e.g. the payee holds at least 10% interest in the company paying dividends for a period of 12 months).
- The profit from the transfer of interest of a parent company in a subsidiary will be exempt from corporate tax. This rule should apply to parent companies that are tax residents in the Czech Republic and subsidiaries that are residents in one of the EU countries (incl. the Czech Republic) as well as residents in a country outside the Europe Union with which the Czech Republic has concluded a double taxation treaty.
- In compliance with the 10th EU directive the Act newly regulates tax neutrality in the case of a division of companies by split-off.
- The tax exemption applicable to interest income from mortgage bonds will be cancelled.

Income Tax – Other Changes

- A debtor will be obliged to increase his/her tax base by the value of outstanding obligations corresponding to the claims that are 36 months overdue or time barred. This rule does not apply to obligations of a debtor that went bankrupt, to obligations with respect to securities, performance for the benefit of the owned capital, compensation for the sustained loss of a company, credits, loans, guarantee, advance payments, penalties from obligations, and further to taxpayers' obligations subject to arbitration, administrative or legal proceedings, or to obligations which have not been claimed as tax expenses. By paying for the obligations in the following tax period it will be possible to reduce the tax base again.

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- The minimum term of financial leasing of movables will be, for tax purposes, equal to the depreciation period of such assets provided for in Section 30 (1) of the Income Tax Act. The minimum term of financial leasing of immovables will be determined as a fixed term of 30 years in comparison with eight years under the current regulation. Rental allowable for tax purposes will be for financial leasing limited by 99% of total rental, for 1% of rental will be considered as so-called financial expense for finance leasing which will be non-deductible for tax purposes. However, such financial expenses will be allowable for tax purposes if they do not exceed in total the amount of CZK 1,000,000 for the tax period. The new amendment will be applied for the first time to the financial expenses for financial leasing resulting from contracts concluded after 31st December 2007 or under annexes agreed to after 31st December 2007 for the contracts concluded prior to this date.
- The rules for asset depreciation will be changed again:
- What is known as "leasing" depreciation will be cancelled. That means that lessors will not be able to apply time depreciation pursuant current Section 30 (4-5) to tangible movables, which will be subject to financial leasing and instead they will apply depreciation pursuant standard rules. This provision will refer to contracts of financial leasing concluded after the amendment becomes effective.
- The 1a depreciation category will be cancelled. Cars will now be included in the second depreciation category and will be depreciated for five years. The depreciation limit of CZK 1.5 million for cars will be cancelled, and therefore it will be possible to claim tax depreciation for cars with acquisition price exceeding CZK 1.5 million upon fulfilment of statutory conditions to the full extent. Cars included in assets prior to the effect of the amendment will be depreciated under the existing provisions.
- The amendment cancels the definition of usual interest on loans, which has been so far determined at the amount of 140% of the discount rate of the CNB.
- Damage incurred as a result of provably administered liquidation of inventory of materials, goods, work in progress, half-finished products and finished goods will become expenses deductible for tax purposes. The taxpayer is obliged to prepare a report on administered liquidation to substantiate the liquidation.
- The limitation of allowability for tax purposes of expenses incurred in connection with temporary accommodation in flats and family houses in the amount of CZK 3,500 and in connection with transport to the place of work will be eliminated and general rules provided for in Sections 24(1) and 24(2) (j) of the Income Tax Act will be applicable for assessment of allowability of such expenses for tax purposes.
- Percentage tax – a rate of 15% will apply to the prevailing majority of incomes subject to percentage tax from 1st January 2008. The rate will be reduced to 12.5% from 1st January 2009. However, the percentage tax on rental from financial leasing from abroad will be increased from 1% to 5%.
- Conditions of creation of adjustments to receivables in the amount exceeding CZK 200,000 will be tightened. It will be possible to create adjustments to such receivables only in cases when such receivables are subject to arbitration or legal or administrative proceedings. The new regulation will be applicable except for receivables for which the creation of adjustments started after 31st December 2007.
- Duty to edit of the Tax Office will be enlarged. Now it will be possible to ask for a binding assessment in respect to :

  - the manner of distribution of expended costs which are connected only partially with taxable income ;
  - the manner in which expenses (costs) are claimed related to running immovables used partially for business activities or lease and partially for private purposes;
  - if an action in respect to assets is a technical improvement, repair or maintenance;
  - if costs incurred in connection with the implementation of research and development projects constitute expenses that can be claimed as a deduction from the tax base under Section 34 (4) and (6) of the Income Tax Act.

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Value Added Tax

- The lower rate of VAT will be increased from 5% to 9%. The basic rate of 19% will remain unchanged. Due to the increase from 5% rate to 9%, VAT on e.g. accommodation services and housing construction that qualifies as social housing will be increased.
- The Act newly defines buildings for social housing the construction, change or repair of which will be subject to the lower rate of VAT.
- The construction of blocks of flats, family houses or flats not qualifying as social housing will be subject to the basic rate of VAT from 1st January 2008. However, it will be possible to claim the lower rate for changes or repairs on such construction until 31st December 2010.
- What is known as group registration for companies related by capital or otherwise will be newly introduced.

Sickness Insurance

- Sick pay will be reduced.
- Employees will not receive sick pay, salary or civil office income for the first three days of sick leave.
- Sick pay will be provided in the amount of 60 % of the daily assessment base: 4th – 30th day of sickness, 66 % of the daily assessment base: 31st – 60th day of sickness, 72 % of the daily assessment base: from 61st day of sickness.
- The effective date of the new Act No. 187/2006 approved last year, which was postponed to 1st January 2008, will be postponed by another year, to 1st January 2009. This Act e.g. passes the obligation to compensate for wages in case of an employee's sickness to the employer for the first two weeks of sick leave.

Social Security and Health Insurance

- The rates for contributions for 2008 will remain the same. The amount of contributions to social security will be reduced to 25% in 2009 and to 24.1% from 2010.
- The annual assessment base will be equal to 48-times the average salary (approx. CZK 960,000) and will apply to both employees and self-employed persons. That means that a ceiling in the annual assessment base will be newly introduced for employees.
- The definition of cleared income will be amended as a performance which has been in monetary or non-monetary form or in the form of benefit provided by the employer to employees or transferred for their benefit, or possibly placed to their credit, or it consists in another form of performance carried out by the employer for the employee. Therefore, also private use of company cars will be now included in the assessment base.
- The assessment base will not include performance provided after the termination of employment if it is provided after the expiry of 1 year from the termination of employment.

Property Taxation

- Also the second group of taxpayers (i.e. brothers and sisters, aunts, uncles, nieces, nephews) will be exempt from paying inheritance tax. So far only direct descendants and spouses have not been obliged to pay inheritance tax.
- Similarly, both direct descendants and spouses, and now also persons included in the second group of relatives will not be obliged to pay gift tax.

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Other Amendments

- The requirement to use fiscal cash registers will be cancelled.
- New ecological taxes on electricity, natural and other gases and on solid fuels will be introduced.

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