



# CZECH REPUBLIC

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## LIST OF ABBREVIATIONS

<b>Agreement</b>	Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments
<b>Directive</b>	Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payment made between associated companies of different Member States
<b>Coll.</b>	<i>Collection of Laws</i>
<b>Merger Directive</b>	Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States
<b>OECD</b>	Organization for Economic Cooperation and Development
<b>OECD MC</b>	OECD Model Tax Convention 2003
<b>Parent-Subsidiary Directive</b>	Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States
<b>Savings Directive</b>	Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments
<b>ZDP</b>	<i>Zakon o dani z prijmu</i> (Income Tax Act)
<b>ZSDP</b>	<i>Zakon o sprave dani a poplatku</i> (Tax Administration Act)

## **LIST OF LEGAL REFERENCES**

### *Laws*

- Income Tax Act, 586/1992 (Zákon o daních z příjmu).
- Tax Administration Act, 337/1992 (Zákon o správě daní a poplatku).
- Act 438/2003 Coll. on the Amending of Act 586/1992 Coll. on Income Tax.
- Act 669/2004 Coll., on the Amending of Act 586/1992 Coll. on Income Tax.

### *Decrees*

- Decree of the Ministry of Finance on allowing certain expenses in determining the tax base of the permanent establishments of the foreign persons, published in the Financial Bulletin number 7-8/1992, under the section 48, with reference number: 11/3-14656/92.
- Decree D-282 of the Ministry of Finance of 18 May 2005 on the information duties of paying agent by payments of interest and on the Agreement between the EU and Switzerland (Agreement) published under the reference number 49/51137/2005-491.
- Decree 43/2005 FZ of the Ministry of Finance published in the Financial Bulletin on 13 of October 2005 with the reference number 49/85663/2005-493 on Taxation of Czech Source Income of Non-Residents in the Czech Republic.

## PART I. IMPLEMENTATION OF THE DIRECTIVE

### 1. INTRODUCTION

#### 1.1. GENERAL INFORMATION ON THE IMPLEMENTATION OF THE DIRECTIVE

The implementation of Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payment made between associated companies of different Member States (the "Directive"), as amended, was carried out by Act 438/2003 Coll., on the Amending of Act 586/1992 Coll. on Income Tax (Zákon o daních z příjmu, "ZDP"). Further amendments to the relevant provisions of the Czech law were carried out by Act 669/2004 Coll., on the Amending of Act on Income Tax.

The Council Directive 2004/76/EC of 29 April 2004 amending the Directive allows the Czech Republic to tax royalties paid to other Member States under Czech income tax law and any applicable treaty up to a rate of 10%. The transitional period ends on 30 June 2011. However, under the domestic implementing provisions, the tax exemption on royalty payments will be generally effective already from 1 January 2011.

The relevant provisions covering interest payments became effective on 1 May 2004, the day of accession to the EU.

The following table shows the relevant provisions of the amended Income Tax Act implementing the Directive.

Articles of the Directive	Relevant sections of Income Tax Act
Art. 1	19(1)(zj) 19(1)(zk) 19(3) 19(5) 19(6) 38nb
Art. 2	19(1)(zk) 19(7) 19(3)(a)
Art. 3	22(2) 23(7)
Art. 4	19(1)(zk) 22(1)(g)(3) 23(7) 25(1)(w)
Art. 5 (1) and (2)	-
Art. 7	-

## 1.2. TAX TREATMENT OF INTEREST AND ROYALTY PAYMENTS UNDER GENERAL TAX LAW

### 1.2.1. Domestic rules

#### *a. Interest*

##### Interest paid

Interest is generally deductible in computing the company's income, provided it was incurred for business purposes and the remuneration applied is not excessive. Special provisions described below affect the deductibility of interest.

##### *Arm's length interest*

A special provision setting out the transfer pricing principles applies to determine the arm's length amount of interest on related-party loans (ZDP section 23 paragraph 7). The arm's length interest rate is set at 140% of the Czech National Bank discount rate. Excess interest is treated as profit distribution the purposes of determining the applicable withholding tax rate (ZDP section 22 paragraph 1 letter G point 3).

##### *Thin capitalization rules*

Under the thin capitalization provisions (ZDP section 25 paragraph 1 letter W), interest paid on loans provided by related parties in excess of a ratio of 4:1 between the aggregate value of the foreign debt and all of the equity of a company is not deductible for tax purposes. The ratio for banks and insurance companies is 6:1. Loans used for the acquisition of fixed assets (see below) and any interest-free loans are not treated as debt for thin capitalization purposes. No thin capitalization rules apply to loans from an unrelated resident.

Interest in excess of the permitted limits is not deductible and for the purposes of determining the applicable withholding tax rate it is treated as a profit distribution (ZDP section 22 paragraph 1 letter G point 3).

##### *Interest on loans to acquire fixed assets*

If a loan was used for the acquisition of fixed assets, the interest that was capitalized (i.e. accrued before the assets were put into use and added to the input value of the fixed assets) is not deductible as it accrued, but is subject to the depreciation rules for income tax purposes applicable to the asset acquired.

##### *Interest on loans to acquire shares*

Deduction of interest related to acquisition of a qualified participation (more than 20% of share capital) in a subsidiary is disallowed (ZDP section 25 paragraph 1 letter ZK). The loans acquired 6 months before the acquisition of such participation are considered to be related to the purchase, unless the taxpayer proves otherwise. The interest related to this loan remains non-deductible during the period of duration of this participation or even upon its transfer to a related party.

##### *Withholding taxes*

There is no withholding tax levied on interest paid to resident companies. Interest paid to the non-resident companies is subject to a final withholding tax at a rate of 15%. The rate may be reduced under a tax treaty (see 1.2.2. Treaties).

##### Interest received

Interest income derived by resident companies is generally included in the taxable income and subject to general corporate income tax rate.

Any foreign withholding tax rate levied on the inbound interest may be credited against the Czech tax liability only if the applicable tax treaty provides so. No unilateral credit relief is available. Withholding taxes paid abroad are, however, deductible as expenses if the underlying income is included in the Czech taxable base.

*b. Royalty*

Royalty paid

Royalty is generally deductible in computing the company's income, provided it was incurred for business purposes and the remuneration applied is not excessive.

Under the general transfer pricing provisions, royalty or part of it paid between the related parties differing from that, which would have been paid between unrelated parties, is not deductible (ZDP section 23 paragraph 7). For the purposes of determining the applicable withholding tax rate it is treated as a profit distribution (ZDP section 22 paragraph 1 letter G point 3).

There is no withholding tax levied on royalty paid to resident companies. Royalties paid to non-resident companies are subject to a final withholding tax at a rate of 25%. The rate may be reduced under a tax treaty (see 1.2.2. Treaties).

Royalty received

Royalty income derived by resident companies is generally included in the taxable income and subject to general corporate income tax rate.

Any foreign withholding tax rate levied on the inbound royalty may be credited against the Czech tax liability only if the applicable tax treaty provides so. No unilateral credit relief is available. Withholding taxes paid abroad are, however, deductible as expenses if the underlying income is included in the Czech taxable base.

**1.2.2. Treaties**

The Czech Republic has concluded tax treaties with all the EU Member States (see Annex).

In the absence of unilateral double taxation relief, the tax treaties remain important as they make the relief of double taxation possible. For relief of double taxation in respect of interest and royalty payments usually the credit method is being followed. This is particular relevant in the bilateral relations with countries benefiting from the transitional period on interest or royalty payments.

*a. Interest*

It is a general tax treaty negotiation policy of the Czech Republic to provide for the exclusive taxation of interest in the state of residence. Currently, most Czech tax treaties with Member States provide for an exemption from withholding tax on interest in the source state.

However, the treaties with Belgium, Cyprus, Estonia, Greece, Latvia, Lithuania, Poland and Portugal provide for a 10% withholding tax in the source state. With regard to these countries, the implementation of the Directive represents a material change.





*b. Royalties*

It is a general tax treaty negotiation policy of the Czech Republic to provide for a limited taxation in the state of source of the royalty payments. Usually, the Czech treaties allow imposition of a 10% withholding tax on the gross amount of royalties in the source state.

Some tax treaties provide for a withholding tax of only 5% or an exemption for cultural royalties (e.g. payments for the right to use or for the use of copyrights of literary, artistic or scientific work, including cinematograph films) from withholding tax in the source state.

All Czech income tax treaties, with the exception of the tax treaty with Ireland, include payments for the use of, or the right to use, industrial, commercial or scientific equipment in the definition of royalties.

## 2. SCOPE

### 2.1. PAYMENTS

#### 2.1.1. Concept of interest

##### *a. Definition*

The term “interest” is defined in a descriptive way in the Czech tax law. The provisions of Czech tax law provide for a non-exhaustive list of instruments or transactions stating that income arising from those transactions is treated as interest for tax purposes.

The Income Tax Act refers in its sourcing rules (ZDP section 22 paragraph 1 letter G point 4) to interest and other income from loans and credits granted, and deposits and similar income arising from other commercial relations.

While the items of interest mentioned in the previous paragraph generally apply in relation to outbound interest, one of the provisions implementing the Directive and exempting the qualified interest payments from taxation (ZDP section 19 paragraph 1 letter ZK) operates for the purposes of exempting this income with a broader range of items:

- on credits and loans,
- issued bonds,
- certificates of deposit and similar deposits corresponding thereto, and
- bills of exchange by the issuance of which the debtor acquires pecuniary means, and
- similar legal relations arising abroad.

The two lists mentioned by the Income Tax Act are not mutually exclusive. The second list introduced by the implementing provision solely gives more examples of interest items, while both provisions contain the “similar” item provision, which extends the application on income items with similar nature or substance. In case of any doubts, for the purposes of the exemption the second list mentioned would be applied.

The scope of the concept of interest under the Income Tax Act appears to be sufficiently broad to cover the definition of interest under the Directive.

##### *b. Exclusion of hybrid financial arrangements (Art. 4(1) b)-d))*

The provision implementing the Directive and providing for the exemption of qualified interest payments from tax excludes from its coverage items of income (Art. 4(1) b) and c) of the Directive) in the form of interest on loans and credits, when the creditor has either the right to participate in the debtor's profits due to the credit relationship or an entitlement to exchange its right to interest for a right to participate in the debtor's profits (ZDP section 19 paragraph 1 letter ZK). Such payments would be generally subject to domestic withholding of 15%.

The Czech Republic did not exercise the option for exclusion of perpetual loans (Art. 4 (1) d) of the Directive) from the beneficial treatment to be provided under the Directive.

##### *c. Exclusion of interest reclassified as profit distribution or conflicting arm's length (Art. 4(1) a) and Art. 4(2))*

The implementing provision (ZDP section 19 paragraph 1 letter ZK) excludes from its coverage items of income treated as distribution of profits (ZDP section 22 paragraph 1 letter G point 3) for the reason of the special relationship between the payer and the beneficial

owner of the interest. Interest may be treated as a distribution of profits under thin capitalization or transfer pricing rules (see 1.2.1. *a. Interest* above).

If interest is subject to the profit distribution treatment, the benefits of the Parent-Subsidiary Directive are applicable to the amounts of interest treated as profit distribution, subject to the regular conditions to be fulfilled under the Parent-Subsidiary Directive. Otherwise a domestic rate of withholding tax or the tax treatment under the relevant tax treaty is applicable.

The Czech Republic applies the concept of related parties in relation to the 'special relationship' clause in Art. 4 (2) of the Directive. The term "related parties" has been recently defined in the Czech income tax law under the new transfer pricing rules (ZDP section 23 paragraph 7). This definition of related parties is also relevant for purposes of the Czech thin capitalization rules. The parties are considered to be related when they are related by capital or otherwise.

#### Parties related by capital

Under the amended Czech transfer pricing rules, parties are related by capital if:

- one party participates directly in the capital or voting rights of the other party, or if one party participates directly in the capital or voting rights of more parties; or
- one party participates indirectly in the capital or voting rights of the other party, or if one party participates directly or indirectly in the capital or voting rights of more parties (in order for the parties to be regarded as related by capital, the respective share in capital or voting rights should be at least 25%).

#### Parties related otherwise

Under the amended Czech transfer pricing rules, parties are related otherwise if:

- one party participates in the management or control of the other (participation in a control (audit) commission or a similar control body, as well as the execution of control for consideration, is not deemed to be a participation in control);
- the same entities or individuals who are close persons participate in the control or management of the other parties (in such a case, these other parties are considered to be related; parties are not considered to be otherwise related, if the same person is a Member of the Supervisory Board of both parties);
- they are controlling or controlled parties, as well as parties controlled by the same entity;
- they are individuals who are close persons; and
- they are parties that entered into a commercial relationship largely for the purpose of reducing the tax base or increasing a tax loss.

### **2.1.2. Concept of royalties**

#### *a. Definition*

Unlike for interest, the Income Tax Act sets forth a substantive definition of the term "royalty" in the section dealing with exempt income (ZDP section 19 paragraph 7).

The definition nearly literally corresponds to the definition in the Directive. Under the Czech rules, the concept of "royalty" means a payment of any type representing consideration for the use of, or the right to use, any copyright or similar right of literary, artistic or scientific work, including cinematograph films and film works, software, patents, trademarks, designs or models, plans, secret formulae or processes, or for information concerning industrial and commercial experience (know-how). Payments for the lease or any other use of industrial, commercial or scientific equipment are also regarded as royalties.

*b. Classification of revenue from leasing and software*

The definition of royalties presented above includes the payments for the lease or any other use of industrial, commercial or scientific equipment. Such payments are also regarded as royalties for the purposes of the application 25% withholding tax under general domestic rules. The sourcing rule applicable to this type of payment, however, provides that equipment is to be located on the territory of the Czech Republic (ZDP section 22 paragraph 1 letter G point 5). No withholding tax is charged if the equipment is located outside the territory of the Czech Republic.

The definition of royalty includes the payments for the use or the right to use software. It thus does not cover the payments for sale of the software, but only the payments where the recipient of the payment remains the owner of the software.

*c. Exclusion of royalties reclassified as profit distribution or conflicting arm's length (Art. 4(1) a) and Art. 4(2))*

Excessive royalties that conflict the arm's length principle fall under the Czech general transfer pricing rules (see 1.2.1. *b. Royalty*). Although a similar situation can arise as in the case of excessive interest, the provisions implementing the Directive do not exclude the excessive royalty from the applicability of the implementing provision as they do in case of excessive interest.

## **2.2. COMPANIES**

### **2.2.1. Types of companies benefiting from implementing provisions (Art. 3(a)(i))**

*a. Other types of entities*

Recipient of income

With respect to recipients of interest and royalty income, the Czech implementing provisions restrict the benefits only to "companies that are resident in another Member State" (ZDP section 19 paragraph 1 letters ZJ and ZK). Under the Income Tax Act, a "company that is resident in another Member State" includes entities that are not tax resident under Czech income tax law and:

- take one of the forms listed in the Directive; and
- under the tax laws of a Member State are deemed to be resident in that state for tax purposes and, under the terms of an applicable income tax treaty concluded with a third state, are not deemed to be resident for tax purposes outside the Community; and
- are subject to taxes listed in the Directive that have the same or similar character as Czech corporate income tax without the possibility of exemption or an option to be exempt (ZDP section 19 paragraph 3 letter A).

The provision nearly literally corresponds to the respective rule of the Directive. However, in contrast to Art. 3 (a) (iii) of the Directive, the Czech provisions cited above incorporate the additional requirement stating the company must not have an option to be exempt. The benefits under the Directive can be granted only on the basis of attestation and a ruling issued subsequently by the tax authority (discussed in detail in 3.2. Attestation). The ruling request filed by the recipient must include the proof that the recipient has one of the legal forms listed in the Directive.

#### Payer of income

As for the payer of income, it must be paid either by

- the Czech permanent establishment of the "company that is resident in another Member State"; or
- the commercial legal entities or cooperatives, which have their legal seat or place of effective management in the Czech Republic.

The Czech commercial legal entities, which can have a seat in the Czech Republic, are:

- joint stock company (akciová společnost – "a.s.");
- limited liability company (společnost s ručením omezeným – "s.r.o.");
- general partnership (veřejná obchodní společnost – "v.o.s.");
- limited partnership (komanditní společnost – "k.s."); and
- cooperative ("družstvo").

All these entities are listed in the Annex to the Directive. Since the provisions of the Czech domestic law do not limit the benefits under the Directive to payments made by the entities listed in the Directive, but use the reference to legal seat or place of effective management, the benefits are also granted with respect to payments made by the unlisted commercial legal entities or cooperatives having their seat or place of effective management in the Czech Republic. It also follows that the Czech transparent entities and similar foreign legal entities having their place of effective management in the Czech Republic (see 2.2.1. *b. Hybrid entities* below) fall within the scope of implementing provisions when making interest and royalty payment sourced in the Czech Republic.

#### *b. Hybrid entities*

##### Tax treatment of Czech listed entities

The Czech entities listed in the Annex to the Directive (akciová společnost, společnost s ručením omezeným, veřejná obchodní společnost, komanditní společnost, družstvo) comprise all the commercial entities that can be created under Czech commercial law.

All of these entities are legal entities for civil and commercial law purposes. They are separate legal persons from their members, partners or shareholders. They can enter into contracts under their own legal name.

For tax purposes, Czech joint stock companies (akciová společnost), limited liability companies (společnost s ručením omezeným) and cooperatives ("družstvo") have unlimited tax liability in the Czech Republic. A different tax treatment applies to general partnerships (veřejná obchodní společnost) and limited partnerships (komanditní společnost).

General partnership is a legal entity, which generally is not subject to the Czech corporate income tax. Its partners are jointly and severally liable for the partnership's liabilities under civil and commercial law. The partners are also subject to tax at their individual level either as physical persons or companies. This entity may only act as a withholding agent of the final withholding tax applicable to certain payments (ZDP section 18 paragraph 9). This, however, does not make the entity subject to tax on its worldwide income. This entity is not considered to be a Czech tax resident for the purposes of tax treaties.

Limited partnership is subject to Czech corporate income tax only to the extent that its profits or losses are not attributable to the general partners (i.e. partners with unlimited liability, komplementáři). The part attributable to the general partners is taxed in the same manner as the income derived by the partners of the general partnerships. Limited partnerships are generally treated as Czech tax residents for tax treaty purposes.

#### Application of benefits to Czech partnerships receiving the income

The application of the exemption in another EU Member State to payments received by Czech general and limited partnerships from another EU Member State may raise the issue of whether these entities comply with all the criteria of an associated company resident in an EU Member State set out in Art. 3 of the Directive.

First, these two entities are included in the Directive, so at least one of the three conditions is met. Secondly, although these two entities are not fully or partially subject to the Czech income tax on their worldwide income, the income derived through these entities and attributed to their general partners will be subject to tax in the Czech Republic, irrespective of the fact, whether these entities actually are tax residents in the Czech Republic or not, because any income derived through these entities by their general partners (even from the sources abroad) would be subject to tax in the Czech Republic under the “deemed permanent establishment” provision (ZDP section 22 paragraph 3). Under Czech rules, income from a Czech partnership attributed to non-resident general partners is deemed as income derived through a Czech permanent establishment. Thus, the worldwide income derived through these entities will be subject to tax in the Czech Republic, however it may be subject to tax either as an income of a physical person or as income of legal entity, as the case may be.

The inclusion of these entities into the forms of qualified entities listed in the Annex to Directive may in practice result in situations, when another EU Member State will be providing benefits under the Directive to the physical persons acting as general partners of these entities.

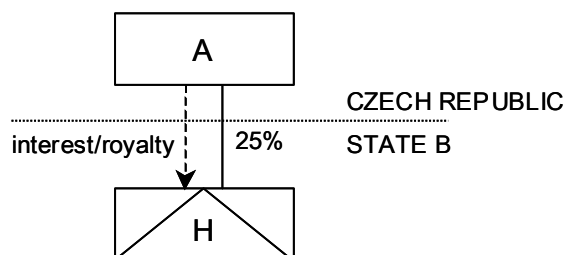
#### Application of benefits to hybrid entities by the Czech Republic

The issue of tax treatment of payments in situations involving hybrid entities is considered based on three hypothetical situations described below:

- Case 1: a Czech entity pays interest and royalties to a hybrid associated entity H located in Member State B;
- Case 2: a Czech hybrid entity H pays interest and royalties to an associated company in Member State A;
- Case 3: a Czech entity pays interest and royalties to an associated company through a hybrid entity H, the latter two located in Member State A.

#### Case 1: Payment to a hybrid entity

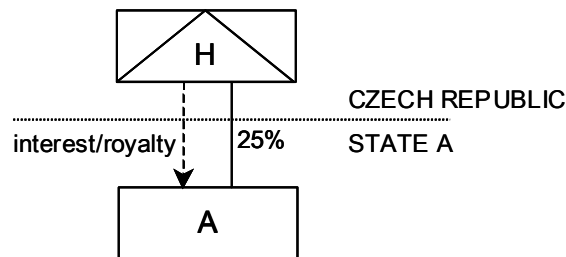
A Czech entity A pays interest and royalties to a hybrid associated entity H situated in Member State B. The Czech Republic treats hybrid entity H as a transparent entity.



In this case the benefits under the Directive would be granted, provided that the foreign hybrid entity meets the above-mentioned criteria of a "company that is resident in another Member State" and the other conditions addressed below. If the foreign hybrid entity fails to present the necessary proof that the conditions are met (tax residence requirement, subject-to-tax requirement, etc.), the exemption would not be granted (please see 2.2.4. Associated company on interpretation of the association requirement).

Case 2: Payment from a hybrid entity

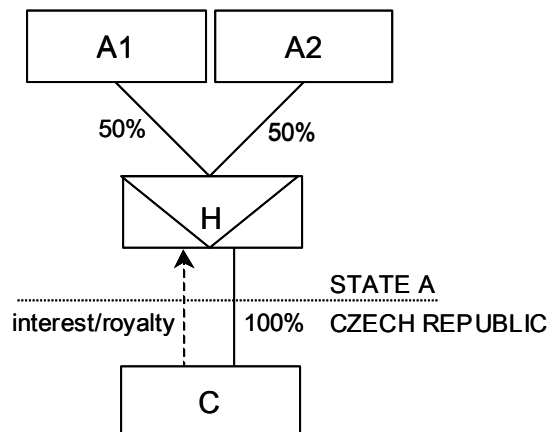
A hybrid entity H in the Czech Republic pays interest or royalties to an associated company A in Member State A.



In this case the benefits will apply because the domestic implementation provisions require that the income must be paid by the commercial legal entities or cooperatives having their seat or place of effective management in the Czech Republic and do not require the paying entity to comply with any other special criteria (ZDP section 19 paragraph 1 letters ZJ and ZK). General partnerships and limited partnerships, which are transparent or may be regarded as partially transparent for tax purposes by other Member States as described above, will certainly qualify for this treatment (see 2.2.1. *b. Hybrid entities* above).

Case 3: Payment through a hybrid entity

Companies A1 and A2 are the members of the hybrid entity H, all located in Member State A. The hybrid entity H holds all the shares in company C, located in the Czech Republic. The Czech Republic treats hybrid entity H as a transparent entity. Company A1 grants a loan to the hybrid entity H and the hybrid entity H grants a loan to the company C. Interest flows from the company C to a member A1 through the hybrid entity H.



The tax treatment in this situation will be identical to that described in Case 1 above.

### 2.2.2. Residence requirement (Art. 3(a)(ii))

#### *a. Implementation of the requirement*

To qualify for the benefits under the Directive, the recipient of the income must be a “company that is resident in another Member State” (ZDP section 19 paragraph 1 letters ZJ and ZK). The definition was introduced by implementation provision (ZDP section 19 paragraph 3 letter A).

The residence concept is incorporated in the definition of the “company that is resident in another Member State”. The term includes entities that are not tax resident under Czech income tax law and are treated to be resident under the tax laws of a Member State in that state for tax purposes and, under the terms of an applicable income tax treaty concluded with a third state, are not deemed to be resident for tax purposes outside the Community (for full definition see 2.2.1. *a. Types of entities*).

It can be noted here that the benefits under the Directive can be granted only on the basis of attestation and a subsequent ruling issued by the tax authority (discussed in detail in 3.2. Attestation). The ruling request filed by the recipient must include, among the other requirements, also a certificate of residency of the recipient issued by a foreign tax authority.

#### *b. Application of the requirement in dual residence cases*

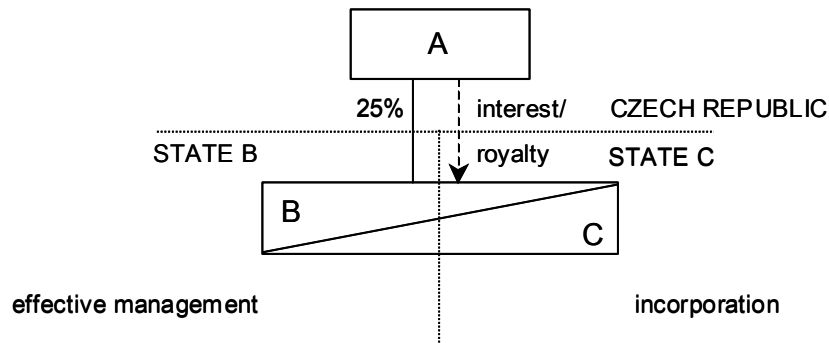
There is no specific guidance with respect to application of exemption from withholding tax when interest or royalties are paid to or from dual resident companies as between Member States. The conclusions on the tax treatment of such payments are drawn on the basis of general implementing provisions of the Income Tax Act. The issue of tax treatment of payments in situations involving dual residency is considered in the three situations described below:

- Case 1: a Czech associated company A makes an interest or royalty payment to a dual resident company BC incorporated in Member State C but with its effective management in State B;
- Case 2: a dual resident company BC incorporated in Member State C but with its effective management in the Czech Republic makes an interest or royalty payment to an associated company A resident in Member State A;
- Case 3: a dual resident company BC incorporated in Czech but with its effective management in State C makes an interest or royalty payment to an associated company A located in Member State A.

#### Case 1: Payment to a dual resident

A Czech associated company A makes an interest or royalty payment to a dual resident company BC incorporated in Member State C but with its effective management in Member State B.

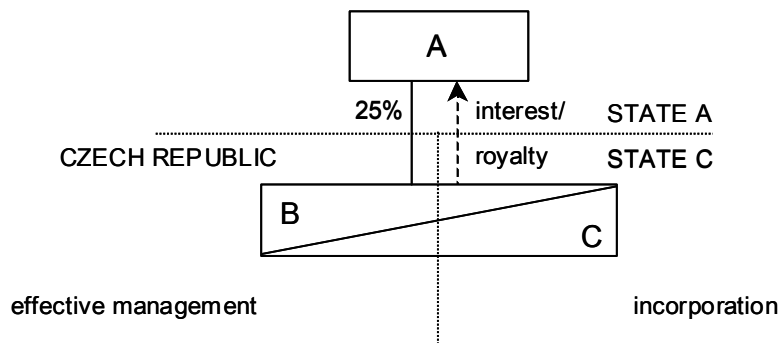




In this case, the benefits of the Directive would be granted, provided the company receiving this income provides the necessary proof of residence for the purposes of obtaining the attestation ruling (discussed in detail in 3.2. Attestation). Although the possibility that the company would be presenting two such certificates of residence is unlikely, it should not be an obstacle of obtaining the benefits under the Directive.

Case 2: Payment by a dual resident with the place of management in the Czech Republic

A dual resident company BC incorporated in Member State C but with its effective management in the Czech Republic makes an interest or royalty payment to an associated company A resident in Member State A.



In this case, the income covered by the Directive is paid by the company that is a dual resident of two different Member States, one of which would be Czech Republic. In this situation the issue would be resolved by the application of the tie-breaker rules contained in the tax treaty, assigning the residence of the company either to the Czech Republic or to the other Member State. It must be noted, that in Czech tax treaties it is not always the place of effective management criteria, e.g., in relation to the Baltic States (Estonia, Latvia and Lithuania) the place of effective management criterion is absent and replaced by the mutual agreement procedure.

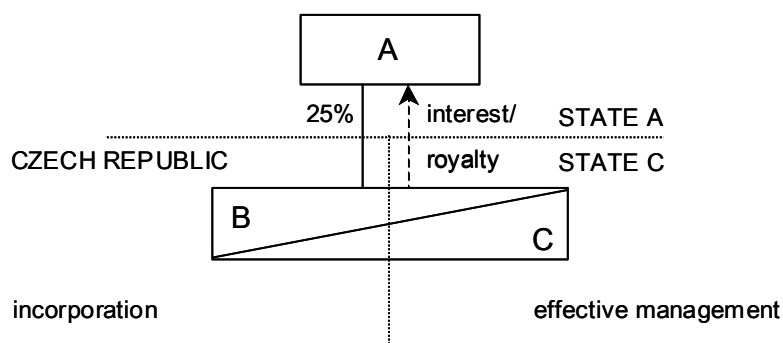
The benefits under the Directive would be granted in this situation. The Czech tax law does not link the benefits under the Directive to the actual effective residency for Czech tax purposes, but to the existence of either the legal seat or the place of effective management in the territory of the Czech Republic. For this reason there would not seem to be a legitimate

ground for the Czech tax authority to refuse granting the attestation ruling because in a dual residency situation as shown above the paying company meets the conditions for obtaining the benefit as it has a place of effective management on the territory of the Czech Republic.

In situations, when as a result of applying the tax treaty tie-breaker rules the company would not be considered a resident of the Czech Republic, but of the other Member State, the Czech Republic could tax such income only in situation, when the income is borne by the Czech permanent establishment of the company of the other contracting state (ZDP section 22 paragraph 1 letter G points 1, 2, 4, 5). In such a case, the benefits under the Directive would be granted. In other cases there would be no need to discuss the benefits, because the Czech Republic would not be able to tax such income in the first place.

#### Case 3: Payment by a dual resident with the place of incorporation in the Czech Republic

A dual resident company BC incorporated in the Czech Republic but with its effective management in State C makes an interest or royalty payment to an associated company A located in Member State A.



In this case the Czech Republic would grant the benefits under the Directive for the same reason valid for Case 2 above. Czech tax law does not link the benefits under the Directive to the actual effective residency for Czech tax purposes but to the existence of either the legal seat or the place of effective management. The company BC satisfies the criteria of having legal seat in the Czech Republic and there seem to be no grounds for the tax authorities to deny the benefits under the Directive.

#### **2.2.3. Subject-to-tax requirement (Art. 3(a)(iii))**

The subject-to-tax requirement was introduced with the definition of the term "company that is resident in another Member State" (ZDP section 19 paragraph 3 letter A, for full definition see 2.2.1. a. *Types of entities*). This term requires qualifying entities to be subject to taxes listed in the Directive that have the same or similar character as Czech corporate income tax without the possibility of exemption or an option to be exempt. As have been already mentioned, in contrast to Art. 3 (a) (iii) of the Directive, the Czech subject-to-tax rule incorporate the additional requirement stating the company must not have an option to be exempt.

It follows that the subject-to-tax requirement relates to the company itself and not to the particular income received and covered by the Directive.

No instances of refusal to accept an assurance by the residence state of the “beneficial owner” that the latter is subject to tax in its Member State have been reported in the Czech Republic.

The benefits under the Directive can be granted only on the basis of attestation and a subsequent ruling issued on its basis by the tax authority (discussed in detail in 3.2. Attestation). The ruling request filed by the recipient must include among the other requirements also the confirmation issued by the foreign tax authorities that the recipient is subject to the taxes listed in the Directive that have the same or a similar character as the Czech income tax. The addendum “that have the same or similar character as the Czech income tax” might be understood either as an additional criterion that such taxes are similar to that of Czech income tax, or it could be also understood as a mere explanation of the kind of these taxes listed in the Directive. The second interpretation seems to be correct, since it is also provided (ZDP section 19 paragraph 3 letter A point 3) that the Ministry of Finance would publish the list of such taxes. The list of the particular taxes was published in the Official Bulletin on 30 June 2004 (Sdělení k § 19 odst. 3 písm. a) zákona č. 586/1992 Sb., o daních z příjmu) and can also be found at [www.mfcr.cz](http://www.mfcr.cz) and merely reproduces the list of taxes in the Annex to the Directive.

There is no guidance with respect to application of the subject-to-tax criterion in situations involving hybrid entities. To qualify for the benefits under the Directive, hybrid entities need to meet the general requirements laid down by the implementing provisions. Failure to present the confirmation from the foreign tax authorities mentioned above will result in the denial of the benefits.

#### **2.2.4. Associated company (Art. 3(b))**

The implementation provisions make availability of the benefits under the Directive subject to the condition of the payment taking place between associated companies (ZDP section 19 paragraph 5 point 1). The association criterion is met if the entity making the payment and the recipient of the payment are “parties directly related by capital”. The term “parties directly related by capital” is newly defined in Czech income tax law under the new transfer pricing rules (ZDP section 23 paragraph 7 letter A point 1).

Under the Income Tax Act, all the parties involved are “directly related by capital” if:

- (1) one party participates directly in the capital or voting rights of the other party, or one party participates directly in the capital or voting rights of more parties; and
- (2) the respective share represents at least a 25% share in capital or voting rights.

The Czech Republic does not apply a lower ownership threshold than the one in the Directive and it exercised the option to apply a holding period provided for in Art. 1 (10) of the Directive. The holding of capital requirement provides for both possibilities of the holding of share capital or the holding of voting rights, while both criteria do not have to apply at the same time (see 3.1. Minimum holding period).

Interestingly, the holding requirement does not strictly involve only companies resident in the EU. In situation of a payment between sister entities, the relevant provisions of Czech income tax law do not require that the parent company be a resident of a Member State and moreover allow an individual to act as the holding element.

There is no general extension of benefits to situations of indirect holdings. However, in relation to hybrid entities, according to unofficial information from the Czech Ministry of Finance the direct holding requirement could be interpreted as to allow, for the part of income flowing such entity to the individual partners, to apply the direct holding criteria at the level of those partners, irrespective of the fact that for the Czech civil or commercial law purposes the direct holding requirement involves the first level of shareholding. There is no general

interpretative guidance or official ruling in this respect. Since the legal terminology used in the Income Tax Act operates with the term "direct holding", in practice the benefits under the Directive may not be granted unless the Ministry of Finance issues an official ruling on interpretation. Currently, such a ruling is being considered in the Ministry of Finance.

It can be noted here that the benefits under the Directive can be granted only on the basis of attestation and a subsequent ruling issued on its basis by the tax authority (discussed in detail in 3.2. Attestation). The ruling request filed by the recipient must include information proving that the entity making the payment and the recipient of the payment are parties directly related by capital and that the requirement concerning the duration of this relationship is met.

#### **2.2.5. Beneficial ownership (Art. 1(4))**

The implementing provisions make the granting of the benefits under the Directive subject to the condition that the recipient is the beneficial owner of the income (ZDP section 19 paragraph 5 point 1).

The term "beneficial owner" has been introduced for the first time in Czech income tax law with the provisions implementing the Directive (ZDP section 19 paragraph 6). Up to 31 December 2003, the term "beneficial owner" was used only in Czech income tax treaties. The definition of the beneficial owner now nearly literally corresponds to the wording used in the Directive. The recipient of the interest and royalties is the beneficial owner if it received those payments for its own benefit and not as an intermediary, agent or authorized signatory.

The condition that the recipient of the income is the "company that is a resident in another Member State" and is subject to taxes listed in the Directive that have the same or similar character as Czech corporate income tax without the possibility of exemption or an option to be exempt (ZDP section 19 paragraph 3 letter A point 3) needs to be met in conjunction with the beneficial owner requirement, which is the only link between the two conditions.

It can be noted here that the benefits under the Directive can be granted only on the basis of attestation (ZDP section 38nb) and a ruling issued on its basis by the tax authority (discussed in detail in 3.2.). The ruling request filed by the recipient must include among the other requirements also the proof that the recipient is the beneficial owner of the interest or royalties.

There is no prescribed form for such a proof. In a recent administrative guidance of the Ministry of Finance published on 13 of October 2005 on the application of tax treaties, the beneficial ownership of income is demonstrated by a written affidavit of the recipient of the income. It seems that a written statement in the form of affidavit would be also sufficient for the purposes of application of benefits under the Directive.

### **2.3. PERMANENT ESTABLISHMENTS**

#### **2.3.1. Definition (Art. 3(c))**

There were no specific provisions introduced in the context of implementation of the Directive in respect to definition of permanent establishment. Therefore the general concept of permanent establishment under Czech tax law applies, with the limitations introduced by particular tax treaty.

A permanent establishment is defined as facilities located in the Czech Republic for the exercise of an activity, including building sites (after 6 months), workshops, offices, facilities for the exploitation of natural resources and market places (ZDP section 22 (2)).

The notion of permanent establishment under the Income Tax Act includes a so-called "services permanent establishment" (ZDP section 22 (2)). The provision of services in the Czech Republic by independent professionals and employees of a non-resident entity which generates Czech-source income constitutes a permanent establishment if the services are provided in the Czech Republic for at least 6 months in any 12-month period (ZDP section 22 (2)). This "services permanent establishment" does not require a single fixed place of business, or a single client. The "services permanent establishment" will arise in case the foreign enterprise provides its services for at least 6 months in any 12-month period on the territory of the Czech Republic. The services permanent establishment will be created in the Czech Republic under Art. 5 of any relevant tax treaty, which follows Art. 5 of the OECD MC.

In addition, the income derived by a non-resident general partner of a partnership or a member of an association without legal personality, with respect to the participation, or from credits and loans granted to the partnership, is treated as income from a permanent establishment (ZDP section 22 paragraph 3). The permanent establishment of a partner in partnership arises even if the non-resident partner does not personally visit the country. That means that interest on credits or loans granted to a Czech partnership by the non-resident partner satisfying the criteria of a "company that is a resident in another Member State", is also treated as income from a permanent establishment in the Czech Republic. The same applies under the tax treaties concluded by the Czech Republic.

Under the Czech domestic tax law, an enterprise is not treated as having a permanent establishment in the Czech Republic in a situation corresponding to the one defined in Art. 5 (6) of the OECD MC when a dependent agent is acting on behalf of the enterprise.

There is no exception for auxiliary activities under the domestic tax law. A permanent establishment arises in situations when auxiliary activities are performed on the territory of the Czech Republic unless restricted by the applicable tax treaty. Since Czech Republic concluded tax treaties with all the Members States following the OECD MC, the exception for auxiliary activities would effectively apply in relation to enterprises resident in the other Member States.

### **2.3.2. Application of source rules (Art. 1(2))**

In the case of the Czech Republic, the domestic definition of permanent establishment is generally broader or more detailed than the definition set out in the Art. 3 (c) of the Directive.

The Czech Republic would levy a withholding tax on the income covered by the Directive only if it was paid by the Czech permanent establishment of non-resident enterprises as defined by the Czech tax law (with applicable tax treaty limitations) or by the commercial legal entities or cooperatives having their seat or place of effective management in the Czech Republic. The Czech Republic would thus not levy withholding tax on the income covered by the Directive unless it was borne by the Czech tax resident or by the permanent establishment as defined by the Czech tax law.

In addition, under the tax treaties concluded with all the Member States, the sourcing rule related to the payments of interest resembling Art. 11 (5) of the OECD MC would prevent the Czech Republic to levy a withholding tax on such interest, unless such interest would be deemed to arise on the territory of the Czech Republic.

### 2.3.3. 'Tax-deductible expense' requirement (Art. 1(3))

The 'tax-deductible expense' requirement under Art. 1 (3) of the Directive has not been explicitly implemented into the Czech tax law. Currently, the Czech tax law does not require interest or royalty payment to be deductible for tax purposes in order to qualify for an exemption.

Due to the absence of this requirement, the benefits of the Directive would be therefore granted even if the income covered by the Directive is not allowed as a tax-deductible expense unless a withholding tax is charged on non-deductible interest reclassified as profit distribution (see 2.1.1. c. *Exclusion of interest reclassified as profit distribution or conflicting arm's length*).

It should be noted that the deductibility of interest or royalty payments borne by a permanent establishment in the Czech Republic may be restricted in accordance with the rules laid down in a Decree on allowing certain expenses in determining the tax base of the permanent establishments of the foreign persons published by the Czech Ministry of Finance in 1992.

### 2.3.4. Beneficial ownership (Art. 1(5))

The Czech tax law does not particularly address the issue of the beneficial ownership in relation to permanent establishments.

The implementing provisions only make the benefits conditional upon the fact that the recipient of the income is a beneficial owner of that income and that it is a "company that is resident in another Member State". The implementing provisions do not make a distinction between the head office or the permanent establishment being the beneficial owner of income. It follows that the general rules related to the beneficial ownership of the income by the "company that is resident in another Member State" apply also to permanent establishments (see 2.2.5. Beneficial ownership).

Since the Czech Republic applies the beneficial ownership test for companies under Art. 1 (4) of the Directive with respect to permanent establishments, there is no specific requirement for the income to be 'effectively connected' or 'subject-to-tax'. It thus might be possible that interest or royalties, while beneficially owned by "company that is resident in another Member State" which is "subject to tax listed in the Directive", are not be subject to tax anywhere. This would be the case when, e.g., this income is not taxed in the Member State of the receiving permanent establishment and a head office state operates an exemption system with respect to the income of permanent establishments located abroad.

### 2.3.5. Permanent establishment in a third country (Art. 1(8))

The Czech implementing provisions limit the benefits under the Directive when income covered by the Directive is attributable to:

- a permanent establishment located on the territory of the Czech Republic (the income would make part of the business profits of the permanent establishment and would be taxed in the normal manner); or
- a permanent establishment located on the territory of a third country (ZDP section 19 paragraph 5 point 3).

The application of the limitation in respect of permanent establishments in third countries might cause certain difficulties in practice. The ruling request is filed by "a company, resident in another EU Member State". The request must include, among the other requirements, the proof that the recipient is the beneficial owner of the interest or royalties, however, it does not



require a proof that the income is not attributed to a permanent establishment of the receiving enterprise located in a third country. This may open the way to avoid this limitation in practice.

### **3. PROCEDURE**

A holding period requirement applies. An exemption is granted at source after the recipient has obtained a ruling from the tax administration. No specific refund procedure has been introduced in Czech income tax law in connection with the implementation of the Directive.

#### **3.1. MINIMUM HOLDING PERIOD (ART. 1(10))**

##### **3.1.1. General**

The benefits from the Directive would be granted only if the entity making the payment and the recipient of the payment are parties directly related by capital and this relation lasts for an uninterrupted period of at least 24 consecutive months.

##### **3.1.2. Relief before the holding period requirement is satisfied**

The benefits can be also granted prior to expiry of this period, subject to the condition that the holding period requirement would be met subsequently (ZDP section 19 paragraph 5). There are no additional requirements for application of benefits before the holding period condition is satisfied.

If the condition is not fulfilled, both the recipient and the payer of the income will be subject to the tax liability. In the case of the recipient (the taxpayer), it will be considered as a failure to meet his tax liability in the fiscal year when the event took place. As for the payer of the income (withholding agent), the amount of the tax, which was not withheld can be claimed as this company's liability (ZDP section 38d paragraph 5). The payer will be held liable for failure to pay a tax due. The amount paid to the recipient would be considered the net amount and would be grossed up, taken the respective withholding tax into consideration (ZDP section 38s).

##### **3.1.3. Appeals**

There is no specific provision concerning appeal of a decision not to regard the requirement of holding as being fulfilled. There is however the possibility to appeal the decision of tax authority under the general tax procedure provisions (ZSDP section 48).

#### **3.2. ATTESTATION (ART. 1(11) AND 1(13))**

##### **3.2.1. General**

To obtain the benefits under the Directive the recipient of the income needs to apply for a ruling from the tax administration by submitting an attestation.

The application for the ruling can be submitted either by the recipient of the income or alternatively by the payer of the income. The attestation must be submitted to the tax authority which is competent with respect to the recipient. It is the Financial Office for Prague 1, which is to be used for recipients that do not have any other taxable presence in the Czech Republic.



The ruling request (attestation) filed by the recipient must include:

- a certificate of residency of the recipient issued by a foreign tax authority;
- proof that the recipient is the beneficial owner of the interest or royalties;
- confirmation issued by the foreign tax authorities that the recipient is subject to some of the taxes listed in the Directive that have the same or a similar character as the Czech income tax;
- proof that the recipient has one of the legal forms listed in the Directive;
- proof that the entity making the payment and the recipient of the payment are parties directly related by capital and the duration of the relationship; and
- the legal title (justification) for the payment of interest or royalties.

The information contained in the application must be valid for at least 1 year and may not be older than 3 years. If there is a change in the information contained in the application, which might influence the fulfillment of conditions necessary for the exemption, the recipient must notify without undue delay the entity making the payment and the relevant tax authorities.

Following the submission of an attestation, the tax authority will issue the ruling granting the exemption (see 3.3. Decision on application of the relief).

### **3.2.2. Appeals**

There is no specific provision governing the appeal of a decision of tax authority concerning the attestation. There is however the possibility to appeal the decision of tax authority under the general tax procedure provisions (ZSDP section 48).

### **3.3. DECISION ON APPLICATION OF THE RELIEF (ART. 1(12))**

Following an attestation certifying the fulfillment of the conditions necessary for the exemption (see 3.2.), the relevant tax authority will issue the ruling granting the exemption. The ruling will be issued within 3 months after the recipient has provided all supporting information and proof.

The ruling granting the exemption will specify:

- the information upon which the ruling was issued; and
- the period for which the ruling is effective, whereas the ruling will be issued for at least one taxable period but for no more than three subsequent taxable periods.

There is no other limitation on validity of this ruling.

### **3.4. APPLICATION FOR REFUND (ART. 1(15) AND 1(16))**

#### **3.4.1. General**

No special refund procedure has been introduced in Czech income tax law in connection with the implementation of the Directive. However, excess tax withheld will be refunded in accordance with the general procedure available for refund of excessive tax paid (ZSDP section 64).

In such a case the taxpayer may apply for repayment of the excess tax paid and prove that all the conditions for the exemption were fulfilled (see 3.2. Attestation). If all the conditions for granting the refund are met, the refund is to be paid within 30 days.



### **3.4.2. Appeals**

In case the tax administration refused to repay the excess tax paid, there is a 15 days appeal period, during which the taxpayer may appeal this decision with the tax authority (general appeal procedure under ZSDP section 64 paragraph 8).

## **4. FRAUD AND ABUSE (Art. 5)**

### **4.1. MEASURES UNDER ART. 5(1) OF THE DIRECTIVE**

#### **4.1.1. Domestic**

The Czech tax law contains a general substance-over-form rule allowing the tax authorities to take into account the substance of a particular transaction and to disregard the formal structuring of the transaction. The particular provision reads as follows:

"When applying the tax laws in tax proceedings, the actual content of a legal transaction and other facts decisive for the determination or collection of the tax are taken into account when such transaction appears only formally to be in accordance with the law while in fact deviating from it."

This rule equally applies to transactions falling within the scope of the Directive.

#### **4.1.2. Agreement-based**

Czech tax treaties do not include any specific anti-treaty-shopping provision, except for the general provisions on beneficial ownership and residence. Most of Czech treaties include the term "beneficial ownership". Only the tax treaty with the United States includes a limitation-of-benefits clause that also limits treaty benefits in the Czech Republic.

### **4.2. MEASURES UNDER ART. 5(2) OF THE DIRECTIVE**

The implementation provisions incorporated the term "beneficial ownership" for the first time into the Czech income tax law (see 2.2.5. Beneficial ownership). However, no specific anti-Directive-shopping rule was adopted. There is also lack of any case law giving guidance on how to properly interpret the "beneficial ownership" requirement.

### **4.3. COMPARISON WITH SIMILAR MEASURES UNDER PARENT-SUBSIDIARY AND MERGER DIRECTIVES**

There were no specific anti-abuse provisions introduced in relation to the Parent-Subsidiary and Merger Directives, as there were no such provisions introduced in relation to the Interest and Royalties Directive, except for the introduction of the term and the requirement of "beneficial ownership" (see 2.2.5. Beneficial ownership). See, however, also section 4.1.1 above.

## **5. SUMMARY**

The Czech Republic implemented the Directive in relation to both interest and royalty payments. Implementing provisions apply to royalty payments despite of the 6-year transitional period for the royalty payments, except for the 10% tax rate applicable for 5,5 years (till 31 December 2010) instead of 6 years as authorised by Art. 6 of the Directive.

### Scope

The Czech Republic implemented the Directive to a large extent in accordance with its provisions. There might be however some differences.

The interesting points of implementation lie in the extension of the benefits of the Directive to transparent entities having their legal seat or place of effective management on the territory of the Czech Republic. The associated enterprise requirement goes beyond the requirement of the Directive by not requiring the parent company to be a resident of a Member State in situation involving sister companies and moreover allowing an individual to act as the holding element.

### Procedure

The Czech Republic operates the system of reduction of the withholding tax at source. The submission of attestation and the requirement of the approval decision of the tax authority were introduced. There was no specific refund system introduced, therefore a refund of excess tax under general rules applies.

### Fraud and abuse

There have been no specific anti-abuse provisions introduced in relation to the Directive, except for the term and the requirement of the “beneficial ownership”. Therefore, apart from failure to meet this requirement, the tax authorities can invoke only the general substance-over-form principle.

## **PART II. THE AGREEMENT**

For a period of time it was not exactly clear what measures, if any, would be appropriate with respect to Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the “Agreement”).

On 18 May 2005 the Ministry of Finance of the Czech Republic issued a Decree D-282 on the information duties of paying agent in case of payments of interest and on the Agreement between the EU and Switzerland. The decree refers to Article 15 of the Agreement and informs that it would apply in the Czech Republic as of 1 July 2005. No further guidance is provided.

In addition to the Decree, the Ministry of Finance included a provision dealing with the Agreement into the pending amendment to the Income Tax Act to be adopted by the parliament. If adopted, it will make the provisions implementing the Directive applicable in relation to Switzerland in the same manner as in relation to the other EU Member States. This would mean that the same provisions described above would be applied in relation to Switzerland. The purpose of amendment is to make the taxpayers informed and thus provide security to the taxpayers.

The relevance of the Agreement is to a certain extent limited for the Czech Republic, because the transitional period on royalties will apply in relation to Switzerland till 31 December 2010 similarly as in relation to the other EU Member States. In relation to interest payments, the current tax treaty between Switzerland and the Czech Republic already provides for exclusive taxing rights of the state of residence of the beneficial owner of interest.

## ANNEX

Table of the maximum withholding tax rates on interest and royalty payments under the tax treaties between the Czech Republic and the EU Member States.

EU Member State	Interest	Royalties
Austria	0	0/5 <1>
Belgium	0/10 <2>	0/10 <3>
Cyprus	10	0/5 <1>
Denmark	0	0/5 <1>
Estonia	10	10
Finland	0	0/1/5/10 <4>
France	0	0/5 <1>
Germany	0	5
Greece	10	0/10 <1>
Hungary	0	10
Ireland	0	10
Italy	0	0/5 <1>
Latvia	10	10
Lithuania	10	10
Luxembourg	0	0/10 <1>
Malta	0	5
Netherlands	0	5
Poland	10	5
Portugal	10	10
Slovak Republic	0	0/10 <3>
Slovenia	5	10
Spain	0	0/5 <5>
Sweden	0	0/5 <6>
United Kingdom	0	0/10 <1>

<1> The higher rate applies to industrial royalties.

<2> The lower rate applies, inter alia, to interest on bank loans and deposits.

<3> The higher rate for royalties applies to copyright royalties. In the case of Belgium, the rates apply by virtue of a most-favoured-nation clause of the protocol.



- <4> The 1% rate applies to royalties paid for finance leases of equipment; the 5% rate applies to royalties paid for the use of computer software and operational leases of equipment; the 10% rate applies to industrial royalties in general.
- <5> The lower rate applies to copyright royalties, excluding film royalties.
- <6> The lower rate applies to copyright royalties, including film royalties.



## **UPDATE FOR THE CZECH REPUBLIC**

The amendment of the Czech Income Tax Act, mentioned on page xxix of the Survey for the Czech Republic, was published in the Collection of Laws on 30 December 2005 under number 545/2005 Coll.

As mentioned in the Survey, one of the amendments introduces new paragraph 8 of section 19 of Income Tax Act, which implements the Agreement and confirms thus the extended treatment granted by the Directive also to Swiss companies (qualified companies under Art. 15(2) of the Agreement resident in Switzerland), under the same conditions as in relation to other qualified companies resident in other EU Member States.