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1. Expected Changes in Tax Deductibility of Interest

Following the OECD's BEPS ("Base Erosion and Profit Shifting") initiative, the European Union approved its own anti-tax avoidance directive. Out of the areas covered, the new rules for tax deductibility of interest are expected to have by far the most significant impact on the Czech tax environment. The implementation of the directive is obligatory and the new rules for interest tax deductibility have to become effective as of 1 January 2019 at the latest. As the directive allows some leeway in certain specifics, the Czech Ministry of Finance recently issued a discussion paper with its vision of implementation.

Most importantly, the Ministry's intention is to replace the current thin capitalization test (based on related-party debt / equity ratio) with the new one; the thin capitalization rules would remain applicable only with respect to banks. The new test should allow tax deductible interest only up to 30% of EBITDA (earnings before interest, tax and depreciation).

However, the crucial change in comparison with the current thin capitalization test is the inclusion of interest costs on loans from non-related parties as well as from related ones. Even companies with only bank financing may therefore be denied tax deductibility of interest costs, which could not occur under the current rules.

On the other hand, the directive also allows for some exemptions. Stand-alone entities, which the Ministry intends to define as entities with no related parties, would be exempt entirely and "small" entities with interest costs (defined as net interest costs, i.e. after deduction of any related financial revenues) up to EUR 1 million in total would be exempt as well. The amount for the *de minimis* test is likely to be subject to further discussions, as the directive allows the member states to use the exemption for up to EUR 3 million. Further discussions are also expected with regards to financing costs subject to the test (e.g. FX differences, capitalized interest costs etc.).

We would like to emphasize again that the rules described above are but an initial draft by the Ministry, i.e. they may change in the future. However, the basic framework will have to be implemented as it is derived from an obligatory EU directive. We will keep you informed about any development in this matter.

Should you have any questions regarding the issues above or should you wish to discuss an estimated tax impact in your specific case, please do not hesitate to contact David Andreatta, e-mail: david.andreatta@tpa-group.cz.

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2. Expected Tax Changes Regarding Sublease and Lease Assignment

The wording of the Czech income tax act before the amendment described below did not address all the tax aspects of specific lease relations sufficiently, which complicated commercial arrangements. Most notably, this concerned sublease and lease assignments. To improve the situation, specific provisions have been included in the recent amendment of the income tax act.

A. Sublease

Under the legal framework before the amendment, the sub-lessee does not have a right to depreciate any technical improvement (i.e. essentially any fit-out works) made at its own expense, ultimately leading to a loss of any tax effect on such expenditures. Even if removed at the sublease end, no tax effect can be retained as the write-off of a sub-lessee's technical improvement is not regarded as tax deductible.

The above-mentioned amendment aims to rectify the situation. The sub-lessee will be given the right to depreciate its newly-made technical improvements under the same conditions as within the tenant-landlord relationship. If the improvement is removed, its remaining tax value will be tax deductible at the lease end as well, provided further standard conditions are met. This should therefore help to clarify and simplify sub-lease arrangements.

B. Lease Assignment

The lease assignment situation is more complicated, the crucial part being whether the "new" tenant has the possibility to compensate the "old" tenant for the technical improvement made in the premises – and continue in its tax depreciation.

The amendment of the income tax act should have clarified this issue as well, at least based on the legislator's explanatory report. However, the wording of the amended provisions fails to deliver. The lease assignments will therefore continue to present significant uncertainty for taxpayers.



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To sum up, if you have had complications in sub-lease arrangements connected with the above, the amendment is likely to bring good news to you soon. However, with regards to any implications of lease assignments, the amendment does not seem to bring final clarity to the matter.

Should you have any questions regarding the issues above, please do not hesitate to contact Petr Karpeles, e-mail: petr.karpeles@tpa-group.cz.



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3. Accounting and Tax Consequences of the Expected Change in the FX Rate

Based on the statements issued by the representatives of the Czech National Bank, the CNB has stopped its monetary market interventions. It seems likely that the foreign exchange rate of the Czech Crown will change in the near future as a result; it is widely expected that the Czech Crown will appreciate.

The situation described above could then give rise to foreign exchange gains or losses, depending on the particular situation of each taxpayer and their foreign exchange risk exposure. The FX gains or losses could then also have accounting and tax consequences.

More specifically, material FX gains can be expected for taxpayers having loan financing in a foreign currency, and, conversely, FX losses can be expected in case of those with significant receivables denominated in a foreign currency. Standardly, these FX impacts would be booked into P/L accounts, affecting the accounting profit of the current period and, importantly, also the taxpayer's tax base.

To eliminate the potentially negative impacts of the above for accounting and tax purposes, it may be possible to implement hedge accounting. Hedge accounting is merely an accounting method which can be considered in cases where natural hedging occurs (e.g. in a case of a real estate company with a long-term bank loan in EUR and regular rent income in EUR as well).



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If hedge accounting is implemented, unrealized FX changes with respect to unpaid liabilities and receivables are not booked against P/L accounts, but against special equity funds. This method therefore reflects the accounting profit of the current period more accurately as it is not affected by the revaluation of balance sheet positions due to the fluctuations of the FX rate. Consequently, taxation of such gains or losses can be also avoided.

For the use of the hedge accounting method, comprehensive documentation needs to be prepared, describing the hedged risks, hedging strategies and chosen instruments. Moreover, the efficiency of the hedging needs to be tested both prospectively and retrospectively. We have successfully implemented hedge accounting for many of our clients – should you be interested as well, we will gladly advise you on the matter.

Should you have any questions regarding the issues above, please do not hesitate to contact Radek Stein, e-mail: radek.stein@tpa-group.cz.



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4. Tax Specialist of the Year 2016 Award



Jiří Hlaváč, a TPA partner, received an award in this year's Tax Specialist of the Year competition, in the category titled "The Tax Star in the Area of Mergers and Acquisitions". Including this year's success, Jiří Hlaváč has won this category three times in a row. Jana Skálová, also TPA partner, placed second in the same category and was also among the five finalists for the category of "The Best Lecturer in Taxes".

The purpose of the competition is to choose the best tax specialists, the most helpful tax authority office and a so-called "tax lemon", representing the most troubling issue in the eyes of taxpayers. More than 7,600 votes both from general public and from professionals were submitted during the online polls.



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This Newsletter is a service of TPA

Kind regards

Your TPA Team

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