Fiscal reform and corporate governance in the Czech Republic

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FISCAL REFORM AND CORPORATE GOVERNANCE IN THE CZECH REPUBLIC[1]

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Abstract

Economic integration within the Economic and Monetary Union (EMU) is founded on the euro and on coordination of economic and budgetary policies both mutually and among the Member States. The Czech Republic became a Member State of the EU in May 2004. Under the EU legislation, prior to adopting the euro the Czech Republic must therefore be an EU Member State and must have fulfilled the Maastricht convergence criteria. The convergence criteria (price stability, public finance sustainability as measured by the government deficit and government debt, exchange rate stability, and convergence of longterm interest rates) are defined in Article 121(1) of the Treaty establishing the European Community (EC Treaty) and specified in the Protocol on the convergence criteria and the Protocol on the excessive deficit procedure annexed to the Treaty. Fulfillment of the convergence criteria in a sustainable, and not only one-off, manner is a necessary condition for adoption of the single currency by a Member State with a derogation.

The Czech Republic is currently reporting an excessive deficit, which poses an obstacle on the way towards compliance with Maastrich convergence criteria. Therefore Czech government has decided to solve primarily public finance problems. The Ministry of Finance and the Czech National Bank published the National plan on acceptance of Euro in the Czech Republic which was ratified 11 April 2007 by the government. The National plan represents a technical script for the acceptance of Euro in the Czech Republic but, it does not contain the date of the entrance into the Eurozone.

Early April 2007, the Czech government introduced a planned legislative reform affecting taxes, social security, health insurance etc. The bill introduced by the Czech government contains many significant changes which came into effect from 2008. Moreover 30 April 2007, the Ministry of Finance of the Czech Republic presented a proposal of the Income Taxes Act amendment containing changes arising from the tax reform as well as other

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proposed changes to the Czech government. Moreover the president of the Czech Republic signed the amendment on the stabilization of public finances on 8th October 2007, which brings alterations to the most of the currently valid tax law. The main object of approved changes is to stabilize Czech public finance, but tax and fiscal reform will have a fundamental impact on corporate governance in the Czech Republic.

The aim of a paper is not to summarize all approved modifications (taxes, social security, health insurance, investment incentives etc.), but paper analyzes and points out significant changes which came into effect in year 2008 and focuses on estimated impact and consequences for corporate governance in the Czech Republic in a future period.

Keywords: *tax reform; corporate income tax; value added tax; corporate governance*

JEL codes: *G 3, E 62, H 2*

1 INTRODUCTION

Economic integration within the Economic and Monetary Union (EMU) is founded on the euro and on coordination of economic and budgetary policies both mutually and among the Member States. The Czech Republic became a Member State of the EU in May 2004. Under the EU legislation, prior to adopting the euro the Czech Republic must therefore be an EU Member State and must have fulfilled the Maastricht convergence criteria. The convergence criteria (price stability, public finance sustainability as measured by the government deficit and government debt, exchange rate stability, and convergence of longterm interest rates) are defined in Article 121(1) of the Treaty establishing the European Community (EC Treaty) and specified in the Protocol on the convergence criteria[3] and the Protocol on the excessive deficit procedure annexed to the Treaty. Fulfilment of the convergence criteria in a sustainable, and not only one-off, manner is a necessary condition for adoption of the single currency by a Member State with a derogation[4].

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[3] Protocol on the convergence criteria" referred to in Article 121 of the Treaty establishing the European Community.

[4] Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area (A joint document of the Ministry of Finance of the Czech Republic and the Czech National Bank approved by the Government of the Czech Republic on 25 October 2006).

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Early April, the Czech government introduced a planned legislative reform affecting taxes, social security, health insurance etc. The bill introduced by the Czech government contains many significant changes which came into effect in 2008. Moreover 30 April 2007, the Ministry of Finance of the Czech Republic presented a proposal of the Income Taxes Act amendment containing changes arising from the tax reform as well as other proposed changes to the Czech government.

2 OBJECTIVE AND METHODOLOGY

The main object of approved changes is to stabilize Czech public finance, but tax and fiscal reform will have a fundamental impact on corporate governance in the Czech Republic. The aim of a paper is not to summarize all approved modifications, but paper points out significant changes which came into effect in 2008 and focuses on estimated impact and consequences for corporate governance in the Czech Republic in a future period.

Basic methods of the submitted paper are methods of analysis and deduction.

3 RESULTS AND DISCUSSION

3.1 Tax Reform

The president of the Czech Republic signed the amendment on the stabilization of public finances on 8th October 2007, which brings alterations to the most of the currently valid tax law. Although their formation was motivated by macroeconomic factors, tax reform will have a radical impact on corporate governance in the Czech Republic. Below, the main points of the reform are summarized.

3.1.1 Corporate Income Tax[5]

In 2008-2010 the corporate income tax rate shall be reduced in the following way:

- For the tax period commencing in 2008 – 21%;
- For the tax period commencing in 2009 – 20%;
- For the tax period commencing in 2010 – 19%.

[5] Zákon č. 261/2007 Sb., o stabilizaci veřejných rozpočtů

The rule proposed in the reform whereby the tax rate valid on the first day of the tax period is applied differs from the existing legislation where the rate valid on the last day of the tax period is applied. Such change will be less advantageous for the taxpayers whose tax period is different from the calendar year because they will always apply the lower rate with a delay.

Financial expenses and thin capitalization

The reform will significantly change the thin capitalization rules and the tax deductibility of financial expenses. These will be newly assessed with the use of the five following tests:

1) <u>Maximum amount (limit) for tax deductible financial expenses</u>

Financial expenses will be limited to a certain percentage of the average amount of loans and credits. The maximum percentage will be determined as the average of the reference value of interbank deposit market interest rates for 12-month maturity (i.e. PRIBOR rates for loans denominated in CZK, LIBOR rates for other currencies) increased by 4%;

2) <u>Tax non-deductibility of subordinated debts</u>

Financial expenses arising form loans and credits which will be subordinated to other taxpayer's obligations will be treated as tax non-deductible;

3) <u>Interest tied to profit</u>

Interest arising from loans and credits where interest will be entirely or partly derived from the taxpayer's profit will be treated as tax non-deductible;

4) <u>Thin capitalization – credits from related parties</u>

Tax deductibility of credits from related parties will be newly limited to an amount of three-times (six-times in existing legislation) of debtor's equity in case the credit or loan recipient is a bank or insurance company, or double (four-times in existing legislation) the debtor's equity for other credit and loan recipients;

5) <u>Thin capitalization – credits from non related parties</u>

In case the amount of the Financial expenses arising from credits and loans exceeds CZK 1 million, only financial expenses arising from credits and loans provided by non related parties will be tax deductible, for 2008 up to the amount of six-times debtor's equity (for 2009 four-times the debtor's equity). It is enough to fail one of the above mentioned tests to render the financial expenses tax non-deductible.

Long term assets

Unlike the initial wording of the bill, the final bill retains the current minimum input price limits for recording tangible and intangible fixed assets for tax purposes (i.e. CZK 40,000 for movable assets and CZK 60,000 for immovable assets). Also limits for technical improvements will remain the same.

Depreciation of cars

The depreciation period for cars will be extended from the current 4 to 5 years including cars which are not be fully depreciated as of 1 January 2008. That means that 1a depreciation category cease to exist and cars will be depreciated using 2 depreciation category. It is also proposed that the current input price limitation (CZK 1.5 million) will be cancelled but this relates only to cars acquired in the tax period following the tax period which began in 2007.

Outstanding liabilities

Following the wording of tax reform, tax will newly be assessed on outstanding liabilities that have been overdue for more than 36 months or have become statute-barred. In case of a subsequent settlement, the tax base can be reduced by the value of the liability paid or offset. The bill states number of exception when the above mentioned will not be applied (e.g. liabilities arising from contractual penalties). This provision will also be applied for individuals who receive income from entrepreneurial or other self-employed activities or income from rent (lease).

Finance lease

Changes which came to effect as of 1 January 2008:

- Tax deductibility of rent is paid on finance lease (limit of up to the maximum of 99 % of total lease payments paid). The above restriction is not applied to a rent paid on finance lease of up to CZK 1 million annually;
- Minimum lease period is set differently. For movable assets it is equal to the minimum period of depreciation and for real estate the period will increases from 8 to 30 years;

- Withholding tax rate for rent on finance lease payments distributed abroad increases from the current 1 % rate to 5 %;
- Lessor newly follows general depreciation rules for depreciation of assets (either linear or accelerated depreciation), the possibility of special lease (time) depreciation was cancelled.

The current rules are applied to lease contracts concluded by the end of 2007 until the time the lease ends.

Provisions to receivables

Creation of provisions to receivables whose value exceeds CZK 200,000 are possible (in case the currently valid conditions are met) only if arbitration, legal or administrative proceedings in which the taxpayer is a participant have been initiated with respect to the receivables. The allowed maximum amounts of provisions remain the same, i.e. the provisions can be created up to:

- 20 %
- 33 % (if more than 12 months elapsed since maturity)
- 50 % (if more than 18 months elapsed since maturity)
- 66 % (if more than 24 months elapsed since maturity)
- 80% (if more than 30 months elapsed since maturity)
- 100 % (if more than 36 months elapsed since maturity)

of the value of receivable stated in the balance sheet.

Mortgage bonds

Interest from mortgage bonds issued after 1 January 2008 are not tax exempt. For mortgage bonds issued till the end of 2007, the current legislation (exemption) is applied.

Unification of withholding tax rate

As of 1 January 2008 most types of income become subject to 15 % unified withholding tax rate (except the above mentioned rent on finance lease payments distributed abroad where the rate will be 5 %). As of 1 January 2009 the unified withholding tax rate further decreases to 12.5 % (except the finance lease payments distributed abroad and the income of tax non-residents stated in section 36 (1) b) of the Income Taxes Act where 15 % rate should be retained.

Binding rulings

The bill includes the extension of the so-called "editing obligations" of the tax administrator. The taxpayer are able to request the Financial Authority to issue binding rulings on the following:

- Distinction between technical improvements and repairs and maintenance of property;
- Proportion of expenses (connected with the operation of real estate) of individuals who are partly using the real estate for private purposes;
- Expenses incurred on research and development projects and the possibility to deduct such expenses from the tax base;
- Allocation of costs that can not be allocated solely to taxable income.

Submission of the application to issue a binding ruling are charges amounting to CZK 10,000 each subject to administrative.

3.1.2 Value Added Tax (VAT[6])

The reduced VAT rate is increasing from 5 % to 9 %. This change impacts taxpayers who sell goods or provide services that are subject to the reduced VAT rate to the end customers (e.g. tax payers providing cultural, artistic, sport and hotel services, publishing houses, real estate construction and development as well as pharmaceutical companies etc.).

Housing Construction

Finance reform does not reflect the extension of the exemption for all housing construction for the application of reduced VAT rate by the Czech Republic by the end of 2010. The bill introduces the possibility to apply the reduced VAT rate only to construction designed for the so-called "social dwelling" (apartments whose total floor area does not exceed 120 m^2 and houses whose total floor area does not exceed 350 m^2).

[6] Zákon č. 261/2007 Sb., o stabilizaci veřejných rozpočtů

Group VAT registration

The concept of group registration enabling persons closely bound by financial, economic or organizational links to register for VAT as a group is newly introduced. Members of this group will not necessarily have to apply the VAT on inter-group supplies provided to other members of the group. The group may be registered always as at 1 January of a calendar year. The application for a group VAT registration has to be filed on 31 October of the preceding year at the latest hence the advantage of group registration will probably only become available from 2009 onwards.

Electronic tax return

Starting 1st January 2010, the tax payers whose turnover exceeds CZK 10 million shall be obliged to submit their tax returns including the recapitulative statements in electronic form using electronic signed data messages.

Binding rulings

Newly, the possibility to request the Ministry of Finance to issue binding rulings on whether the taxable supply is included in the basic VAT rate or reduced VAT rate are introduced. Both the provider and the receiver of the taxable supply have the option to require the binding rulings. Submission of the application to issue the binding rulings are charge amounting to CZK 10,000 each subject to an administrative.

3.1.3 Excise dutie

Tax changes affect excise duties as well. Excise duty on tobacco products has been raised and waste oil tax benefits have been repealed. Modification of marginal tax rate are following:
For cigarettes:

- percentage element of duty rate increases from 27 % to 28 %;
- fixed portion of the duty increases from CZK 0.88/piece to CZK 1.03/piece;
- minimum duty rate increases from CZK 1.64/piece to CZK 1.92/piece.

Excise duty on cigars and cigarillos increases from CZK 0.90/piece to CZK 1.15/piece and from CZK 905/kg to CZK 1,280/kg for tobacco products.

Excise duty rate on waste oil increases to CZK 660/1,000 l from the currently applicable CZK 0/1,000 l.

3.2 Legislative changes regarding social security and health insurance7

The legislation on stabilization of public finances also brings changes in the domains of social security and health insurance. Newly, the assessment base for the contributions should be capped so that the employer withholds social security and health insurance contributions from the employees' salary up to the maximum of 4 times the average salary (the average monthly Czech salary currently amounts to app. CZK 22,000).

In case that the employee has more employers during one year, the assessment base is to be determined individually for each employer. Social security and health insurance paid from the total of all assessment bases exceeding the maximum assessment base shall constitute an overpayment which can be refunded to the employee by the Social Security Administration based on a written application. The application has to be submitted within 5 years of the end of the calendar year in which the overpayment arose.

However, in the above case, the employer shall not be entitled to the refund of the overpayment. Every employer keeps track of the maximum assessment base of their employees individually, regardless of the amount of the employees' income from other employers.

An amendment to the Social Security Act decreases the rates of health insurance to be paid by the employer. In 2008, the rates of health insurance for employers reduced from 3.3 % to 2.3 % of the tax base and, in 2009, the health insurance for employers will be further reduced to 1.4% of the tax base.

In connection with the above, currently the Social Security Administration fully refunds the wage compensation paid by the employer to the employee during the first 14 days of sickness. In 2008, the rate of reimbursement reduces to one half of the wage compensation paid by the employer and, in 2009, the wage compensation for the first 14 days of sickness will be fully covered by the employer. In practice, the employer reducs its individual monthly insurance payments in 2007 by the total amount of wage compensation and compensation for temporary work disablement paid to the employees in a month for which the insurance was paid. In 2008, the employer reduces its insurance payments by one half of the total amount of wage compensation and compensation for temporary work disablement paid to the employees in a month for which the insurance was paid, and pay only the resulting difference to the Social Security Administration.

[7] Zákon č. 589/1992 Sb. o pojistném na sociální zabezpečení a příspěvku na státní politiku zaměstnanosti, v platném znění and Zákon č. 592/1992 Sb. o pojistném na všeobecné zdravotní pojištění, v platném znění.

3.3 Investment incentives[8]

Also approved amendment to the Investment Incentives Act can significantly influence corporate governance in a future period. Act contains following changes to be met conditions for granting investment incentives:

- the minimum investment amount is reduced to CZK 100 million (currently CZK 200 million), of which at least CZK 50 million (currently CZK 100 million) must be financed from the investor´s equity capital,
- an increase of minimum investment ratio in to machinery to 60 % (currently 40 %) of the total investment,
- only new machinery (currently machinery not used in the Czech Republic before acquistion) not older than 2 years (currently not limited) can be included when calculating this ratio,
- postponement of the moment, from which the state - aided investment acquistion of fixed assets, commencement of construction works) can commmence.

Time period for utilization of the tax relief as a form of the investment encentives is reduced to 5 years (currently 10 years). The new rules applies to aplications for investment incentives filled after the effective date (i.e. from 2.7.2007) of the amendment. Investment encentives approved should not be affected by the amendment.

4 CONCLUSION

The launch of the public finance reform the Czech economy to move towards a position in which it could be able to aspire to adopt the euro. But approved changes also significantly modify environment of corporate governance in the Czech Republic. The corporate income tax decreases from current 24 % to 21 % in 2008, 20 % in 2009 and 19 % in 2010. Lower VAT tax applied to food, drugs, books, apartments, culture increases from 5 % to 9 %. Tax reform leads also to changes in excise tax for cigarettes and tobacco products. The legislation on stabilization of public finances brings as well changes in the domains of social security and health insurance. Approved amendment to the Investment Incentives Act can substantially influence corporate governance in a future period. While the direct impact of the lower corporate income tax is relatively small, the complex of legislation on stabilization of public finances should provide a motivation to the economy, i.e. increase in labour productivity or help to higher amount of foreing direct investment.

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[8] Novela zákona č. 72/2000 Sb., o investičních pobídkách.

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[18] Zákon č. 592/1992 Sb. o pojistném na všeobecné zdravotní pojištění, v platném znění.