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Summary of Basic Income Tax Changes to Be Introduced in 2019

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Following up on the VAT changes in the "2019 Tax Package" which we outlined in Tax News No. 3, in this issue we focus on the major changes to be introduced by the amendment to the Income Taxes Act.

Transposing the ATAD

The EU Anti-Tax Avoidance Directive ("ATAD") contains additional anti-tax avoidance rules and measures, which include rules on restricted interest deductibility, exit taxation, a general rule against tax regime abuse, and rules for controlled foreign companies and hybrid mismatches. All such measures apply only to corporate income tax payers.

Restricted deductibility of borrowing costs

Qualified borrowing costs should be deductible from the tax base only up to the particular threshold. Under the draft amendment, the difference between borrowing costs and income is considered to constitute excess borrowing costs. Excess borrowing costs cannot be included in the tax base calculation if they exceed the higher of 30% of the taxable profit before interest, tax and depreciation, or the amount of CZK 80 million.

Unlike the low debt-to-equity swap rule, which will continue to be in the Income Taxes Act, the deductibility of interest rates also applies to loans and borrowings from unrelated parties. The tax base can be reduced by excluded excessive financial expenses up to the amount of the positive difference between the eligible borrowing costs and the excess borrowing costs over the particular period. Also, rules have been proposed for areas where the restriction does not apply.

Exit taxation

Exit taxation should apply when a Czech company changes its residence and transfers assets from the Czech Republic to a foreign country without any change of ownership or when the company's assets are transferred to a permanent establishment in a foreign country and, similarly, when the assets of a non-resident taxpayer's permanent establishment in the Czech Republic are transferred abroad. In such cases, the transfer is taxed in the same way as a sale of assets to oneself at the arm's length price. This fictitious income can then be reduced by the residual value of the assets, which is then used as a tax expense. This provision should be valid starting in 2020. The payment of the relevant part of the tax may, under certain conditions, be spread out over a period of 5 years.

Taxing controlled foreign companies

Czech parent companies that control more than half of their foreign subsidiaries will have to include in their tax base passive income (i.e. interest, royalties, dividends) or income from artificial transactions of the subsidiary if the subsidiary's tax liability is less than one half the tax which the subsidiary would have paid if it were a Czech resident (the so-called "CFC rule").

This measure provides a fiction that such income of a controlled foreign company which does not have any substantial business operations will be taxed as if it were exercised by the (Czech) controlling company. This measure could discourage multinational companies from artificially transferring passive profits to subsidiaries or permanent establishments in low-tax countries.

Hybrid mismatches

The ATAD includes, among other things, rules to prevent corporate tax avoidance using so-called "hybrid mismatches", which in general may take the form of a double deduction (one amount is included in the tax base calculation as an expenditure in more than one jurisdiction) or a deduction without including income in the tax base (a certain amount is included in tax expenditures in one country without the appropriate inclusion of the same amount in the income when calculating the tax base in another country).

The rule to be included in the act as a tool to combat double deduction is as follows: whenever the deduction is applied, the

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corresponding income will be included in the tax base. In order to avoid actual double taxation, only the difference between the tax-deductible expenditure and the corresponding income included in the tax base should be applied.

As concerns a deduction without inclusion, a deduction is not considered tax deductible (if the affiliate is reducing its tax base) unless the corresponding income is included in the tax base of another affiliate. It will therefore be necessary to assess whether the income is subject to due taxation.

The rules for taxing hybrid mismatches should, as with exit taxation, be implemented into the Income Taxes Act by the end of 2019.

Super-gross wages and personal income tax rates

As concerns employment-generated personal income tax, the amendment proposes cancelling the concept of "super-gross" wages (gross wages plus social security and health insurance premiums paid by the employer). The actual gross income – whether in cash or in kind – should be the tax base.

At the same, there is a proposal to cancel the solidarity tax.

To make up for the solidarity tax, the amendment wishes to introduce a floating progressive tax rate of 19% for tax bases up to CZK 1.5 million and 24% for tax bases that exceed that threshold. Unlike a solidary tax, the progressive tax rate will apply to all types of income.

The amendment provides self-employed individuals (sole proprietors) with the opportunity to deduct up to 75% of paid social security and health insurance premiums from the tax base, in addition to flat-rate expenses. The remaining 25% will be considered non-deductible expenditures, which should correspond to the premium paid by the employees themselves from their wages.

Replacing the uniform personal income tax rate with a progressive rate could mean that the same income could be taxed with different tax rates depending on whether it is generated in the Czech Republic or abroad. Income from the Czech Republic which is subject to withholding tax is taxed at a 15% tax rate. The same income, if paid from abroad, is taxed within the general tax base and would be subject to the new rate of 19% or 24%. In order to maintain neutrality and a uniform taxation regime, a separate tax base for personal income from foreign countries is applied and will be taxed at 15%.

Fair value fluctuations of financial tools

The Amendment to the Income Taxes Act also takes into account the implementation of IFRS 9 into Accounting Regulation No. 501/2002 for banks and other financial institutions, which are thus free to decide to account for the changes in the fair value of securities they choose at their own discretion not to include in profit or loss but in equity. Were it in line with the current Income Taxes Act, profit would not be taxed or losses would not be accounted for if they arise from securities that are voluntarily labelled as securities valued at fair value through equity.

Therefore, a specific rule for such securities is proposed to be included in the Income Taxes Act to ensure that profit is taxed and losses taken into account, including changes in the valuation of securities, at the time the particular transaction is completed.

Although this scenario has been incorporated in the Financial Institutions Decree, it can be expected that the decrees for other accounting entities will be amended accordingly.

Ordinary certificates valued at fair value

Last but not least, the amendment should eliminate an inconsistency in the law where, on one hand, expenses for selling an ordinary certificate are tax deductible and, on the other, the valuation differences for ordinary certificates are excluded from the tax base. Thus, the term "ordinary certificate" will be incorporated into the general term "securities" and will be subject to the same tax procedure.

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We will keep you updated on the further development of the amendment to the Income Taxes Act.

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