



Dear clients,

We meet with many of you nowadays to discuss the tax returns for the past tax period but still we should not forget the future prospects: the government prepares changes for 2019. The current issue of the KempHoogstad Tax News brings you overview of planned measures regarding taxation of physical persons and legal entities. The measures are part of a governmental proposal and – if adopted – they would become effective from 1 January 2019. We will inform you about all the changes that will pass the approval process.

Wishing you pleasant last winter days and the beginning of spring.

The KempHoogstad Team

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Changes to income tax in 2019 under preparation

The government has prepared an amendment to tax laws that should introduce a number of changes starting in 2019. **Personal income should be taxed progressively**, and there should be **changes to assessing the tax base of employees and self-employed persons**.

Legal entities can expect **new rules for the tax deductibility of expenses on financing, taxation of income of a controlled international entity, and taxation of the trans-border transfer of assets**. The Parliament will deal with the Senate's proposal for termination of the advantage of lower taxation for some kinds of investment funds.

Part of the amendment is **a number of changes to VAT** reflecting namely changes to the directives and case law of the European Union and one change regarding the Tax Code that should contain a provision affecting the general abuse of law, i.e. action where the main or one of the main purpose is gaining a tax or other advantage which is contrary to the sense and purpose of the respective legal regulation. We will keep you informed about the proposal for the changes.

The proposed amendment has been passed on for further proceedings, hence it is in the beginning of the approval process. Further changes to the amendment cannot be excluded.

Proposed changes to the taxation of physical persons from 2019

Regarding physical persons, the government proposes changes to the tax rate and assessment of the tax base.

(i) *Introducing progressive taxation of all kinds of income and revocation of the solidarity tax increase*

The tax rate for income below 1.5 million should be 19 per cent and the tax rate for income above that amount should be 24 per cent.

The solidarity tax increase, which is now applied to the income of employees and self-employed persons, should be revoked.

(ii) *Revocation of employees' super-gross salaries*

The tax base should be employee's gross income without deducted social security and health insurance.

(iii) *Social security and health insurance as a taxable expense for self-employed persons*

Self-employed persons would be able to deduct 75 per cent of paid social security and health insurance amounts. In addition, persons using expense allowances should be able to apply the deduction.

Regarding employees and self-employed persons, the changes will have more or less a neutral effect on the amount of their taxation with respect to the amount of their income. Contrary to this, persons with income from renting real estate and other income, e.g. from investing into securities, sale of real estate, etc., will be affected by the introduction of new tax rates, and their taxation will be higher.



Proposed changes to the taxation of legal entities from 2019

Regarding corporate income tax, the prepared governmental amendment includes namely the implementation of rules which follow from the EU Anti-tax Avoidance Directive (ATAD).

(i) *Reducing the deductibility of excessive borrowing costs*

Financial expenses related to received loans, credits, and also leasing and derivatives that exceed possible associated financial revenues will be tax deductible up to the amount of CZK 80 million or up to 30 per cent of the tax revenue before deducting interest, taxation, or deductions, if the latter amount is higher.

The borrowing costs will also include exchange rate differences and interest which is a part of the tax value of long-term asset or financial leasing (relevant to assets put in use or allocated for use after 17 June 2016).

Unrecognised borrowing costs should be possible to claim in a future tax period if the amount of deductibility is not exceeded in those periods.

The rule should be applicable to almost all entities with the exception of selected financial institutions and entities outside the group. The limitation of deductibility also applies to financial costs related to a contractual obligation that arose before the amendment takes effect.

The current rule of thin capitalisation that limits the deductibility of the financial costs of financing from related persons stays unchanged.

(ii) *Taxation of selected income of a foreign controlled company (the CFC rule)*

Selected income of a foreign controlled company (e.g. income from licence fees, profit shares, provided financing, sale of business shares) will be part of the tax base of the Czech controlling company that holds directly or indirectly more than 50 per cent of the share of the controlled company or that participates in more than half of its profit or voting rights. A permanent establishment of a Czech company located in a country with which the Czech Republic concluded a double taxation treaty and according to which income is excluded from double taxation using the exemption method will also be considered a controlled company.

The rule will be applied if the foreign company does not carry out substantial business activity and its taxation abroad is lower than half of its potential tax obligation in the Czech Republic.

Potential tax losses of the foreign controlled company will not be deductible from the tax base of the Czech company but can be deductible from taxable future profit of the controlled company for the subsequent three years.

(iii) *Introducing exit taxation – effective from 2020*

The subject matter of taxation should be the transfer of assets owned by a legal entity from the Czech Republic to abroad without change of ownership of the given assets, i.e. the matter in question is a transfer of assets to a permanent establishment located abroad or a transfer of tax residency abroad.

The difference between the market value and the tax value of the given assets will be taxed. The amendment assumes that the tax could be paid in instalments for a period of up to five years.



(iv) *Solution of hybrid discrepancies – effective from 2020*

The provision should prevent situations arising as a result of the various intra-state rules of individual countries (such as the legal classification of entities, financial instruments, definitions of a permanent establishment) where entities within a group can get tax advantages such as double non-taxation of income or double reduction of the tax base using a deduction of the same expenses. The rules should concern hybrid discrepancies within the member states and also towards third countries.

(v) *Revocation of low taxation for selected investment funds*

The government approved a proposal for the Senate's amendment to the Income Tax Act. According to the amendment, the advantage of reduced taxation using the 5 per cent rate should not be applicable by investment funds that fulfil only the condition that their shares are accepted for trading on the European regulated market. Such funds should be taxed at the same rate as other legal entities, i.e. 19 per cent. The intention is to prevent using the investment funds only for the purpose of tax optimisation of a fund owned by a few owners where the shares are not traded.

Amounts of expense allowances in the 2017 tax returns

With respect to the upcoming deadline for submitting tax returns, we would like to draw your attention to the fact that self-employed persons and persons with income from renting real estate who use lump-sum expense allowances have **the opportunity to claim tax reliefs and tax advantages in their 2017 tax return if they use a reduced amount of expense allowances.**

Self-employed persons and persons with income from renting real estate whose total tax base is comprised of such income of more than 50 per cent can choose whether they use in their 2017 tax return:

- a reduced amount of expense allowances (up to one half). By choosing this method, they can claim tax reliefs for a spouse and tax advantages for children; or
- the original amount of expense allowances without the opportunity to claim tax reliefs for a spouse and tax advantages for children.

The mentioned choice is **relevant for those self-employed persons and landlords** who can (together with fulfilling other conditions) claim tax reliefs for a spouse and tax advantages for children and **whose income from business or renting real estate is above CZK 1,000,000**. In such cases, the advantage of claiming the tax reliefs and tax advantages should be compared with the disadvantage of using reduced maximum amounts (up to half) of expense allowances (maximum of CZK 800,000 for expenses claimed in the amount of 80 per cent of the income, maximum of CZK 600,000 for expenses claimed in the amount of 60 per cent of the income, maximum of CZK 400,000 for expenses claimed in the amount of 40 per cent of the income and maximum of CZK 300,000 for expenses claimed in the amount of 30 per cent of the income).



Self-employed persons and persons with income from renting real estate whose income is less than CZK 1,000,000 can already claim tax reliefs for a spouse and tax advantages in the 2017 tax period because the original higher amounts of expense allowances are not relevant to them.

Please note that **only reduced amounts of expenses allowances will be allowed in the 2018 tax period** together with the claim for tax reliefs and tax advantages. **Reducing the amount of expense allowances can result in** a situation where self-employed persons and persons with income from renting real estate will use **the method of recording the actual costs because it will be more efficient** for them. In such cases, it is necessary to review **the possible impact on the 2017 tax base regarding the mandatory adjustments** of the tax base made because of the change to the method of recording expenses (e.g. subsequent taxation of receivables) which can influence the social security assessment base.

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