

1. Introduction

This report reviews the treatment of foreign exchange (FX) gains and losses within the framework of the Czech tax system. It covers the legal concepts and mainly administrative practices that are relevant to this area and that are used for computation of tax base from transactions conducted in a foreign currency (a currency different from the Czech crown (CZK)). The main tax concepts in this area of the Czech tax system are the result of tax and accounting legislation and in minor part the administrative practice of the tax authorities also plays a role. The administrative practice is important in the area of foreign tax credits and their computation. There are no court decisions of the Supreme Administrative Court of the Czech Republic (*Nejvyšší správní soud CR*, www.nssoud.cz) that would be relevant for this area of tax or accounting law. The report concentrates on the taxation of corporate entities rather than individuals.

1.1. Legal tender and FX controls

The legal tender in the Czech Republic is the Czech crown (*ceska koruna*). The law technically allows the Czech National Bank to apply FX control measures and limit residents in their investments and acceptance of foreign currency. However, the current situation is that none of these restrictions is in place and there are no limits for residents on their investments and dealings in foreign currency. However, applicable obligations of an administrative nature are reporting obligations to the Czech National Bank, as described below.

Residents are free to conclude transactions in foreign currency, including any derivative transactions, and there are no restrictions that would prevent non-residents from dealing in Czech currency; therefore offshore trades in CZK are possible and occur regularly.

Under the current regulations, every direct investment in the Czech Republic by a non-resident must be notified to the Czech National Bank. As of 1 January 2004, such notification was no longer required if the value of the direct investment was less than CZK 1,000,000 (approximately 40,000 euro).

Under the Foreign Exchange Act, direct investment is defined as the use of funds or other ownership rights to which a monetary value can be attributed, as well as other assets to establish, acquire or increase the long-term economic interests of a non-resident in a business in the Czech Republic, particularly in one of the following forms:

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- establishment or acquisition of a majority shareholding (controlling interest) in a business, including any expansion of a business;
- participation in a new or existing business where the investor owns or acquires 10 per cent or more of the registered capital of a trading company or cooperative, or 10 per cent or more of the equity capital of a company, or 10 per cent or more of the voting rights, or any other share in excess of 10 per cent in the business of a company;
- any other provision or acceptance of funds or other assets or ownership rights to which a monetary value can be attributed as part of long-term economic interests established by direct investment;
- a financial credit associated with a profit distribution agreement or with the exercise of a significant influence over the management of business; and
- the use of profits from an existing direct investment in the same investment (re-investment of earnings).

Cashless payments to or from the Czech Republic can only be made through authorized “currency places”. Authorized currency places are banks with their seat in the Czech Republic or an affiliate of a foreign bank that has a bank licence in the Czech Republic, a person who obtained a currency licence issued by the Czech National Bank, a person registered as an exchange office or a person with a unified licence who may buy and sell foreign currencies or may make cash or non-cash transfers related to foreign countries.

Residents are required to report to the Czech National Bank the following data:

- cash receivables and liabilities related to residents abroad and non-residents;
- direct investments, financial loans, stock and bonds and related money transfers to residents abroad and non-residents, operations on financial markets, including operations by non-residents; and
- bank accounts opened abroad or other kinds of money savings abroad.

Both residents and non-residents must produce documents for payment on request. Residents and non-residents carrying on business in the Czech Republic also have certain notification obligations under the currency and anti-money laundering regulations.

The only limitations in the currency control legislation are restrictions for buying real estate by non-residents. Currency regulations make it difficult for non-residents to buy real estate. Generally, residents, non-residents with Czech citizenship, non-residents from a Member State of the European Community with a residence permit in the Czech Republic and non-residents (legal entities) that have a business or its integral part in the Czech Republic and that are entitled to do business in the Czech Republic, may acquire real estate in the Czech Republic. Other non-residents may acquire real estate in the Czech Republic only through inheritance or joint ownership of assets of spouses where one of the spouses is a resident or has Czech citizenship, etc.

1.2. The basic principles of the Czech tax system

Companies and individuals resident in the Czech Republic for tax purposes are liable to tax on their worldwide income. The Czech tax system does not operate any controlled foreign company (CFC) rules and therefore income of non-

resident subsidiaries of Czech taxpayers is not included in the worldwide income of the parent. In this instance the Czech tax system so far does not differentiate whether the subsidiaries are established in a well known offshore tax haven or another EU country. The tax system does not permit group taxation, with the exception of VAT. Non-residents for tax purposes are subject to tax only on their Czech source income or if they are conducting business through a permanent establishment, they are liable to corporate or individual income tax on the income related to the Czech permanent establishment.

The Czech tax system does not typically distinguish between capital gains and income; both forms are therefore included in one system of income taxation. The disadvantage is that no indexation of capital expenditure or other measure for taking inflation into account is allowed. The difference is only at the level of individuals where an individual's income in the form of capital flows used to be taxed at a lower level, e.g. at a level of 15 per cent compared to the general tax rate of 32 per cent. However, the latest changes have significantly reduced the tax burden for individuals and therefore this difference was swept away during the overhaul of the income tax system for individuals and now the rate used for capital flows such as dividends, interest etc., is the same as the general tax rate at the level of 15 per cent.

The Czech tax system is built on the concept that the tax base for corporate taxpayers is computed from the accounting profit/loss result and adjusted by non-deductible expenses and non-taxable revenue. For corporations this means that the area of FX gains and losses depends on the accounting treatment of the underlying transactions and currency used for reporting. The tax law as such does not deal specifically with FX gains and losses and has no comprehensive regime for dealing with FX fluctuations. The tax law rather refers to financial accounting legislation and standards. It is the accounting legislation that deals with the translation of FX based transactions into domestic currency.

In the past until 2003 the tax system was designed differently for financial institutions with the exception of insurance companies and "normal" corporate taxpayers. While financial institutions were subject to tax on an accrual basis and both realized and non-realized FX gains and losses were included into their tax base, normal corporate taxpayers and insurance companies were subject to tax only on the basis of realized FX gains and losses. Currently FX differences form part of the general tax base and FX losses are generally deductible for tax purposes and FX gains are part of taxable income. To soften the impact of the change, for the tax period 2003 taxpayers were allowed to exclude the FX gain from their tax base but one-third of the unrealized capital gain had to be included in each of the three years following the change. It was beneficial for taxpayers to use this option since it not only allowed for postponing the taxation of the unrealized FX gains but also allowed taxpayers to profit from the change to lower corporate income tax rates in the periods concerned.

Tax income needs to be reported in domestic currency and there are no exceptions that would allow the reporting of income in a different currency for tax purposes. For taxpayers that are not obliged to keep books of account the Ministry of Finance publishes on a yearly basis instructions with so-called unified exchange rates for the taxable period that are based on the average exchange rates of the Czech National Bank for the last day of each month of the

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taxable period. So e.g. for the taxable period of 2007 the unified exchange rate was CZK 31.89 for 1 euro.

The tax law specifically stipulates that for tax purposes with exceptions listed within the law only FX rates of the Czech National Bank that are used for the accounts of the taxpayer should be used. The exceptions where the law specifically states which exchange rate of the Czech National Bank shall be used for tax purposes are the calculation of income tax advances to be deducted from employment income and withholding tax from interest income from deposits and current accounts held with a bank denominated in foreign currency.

Since the tax system is designed as a worldwide system, it does not distinguish between geographical sources of the income and specifically FX differences are treated in the tax system as an item without specific source. For tax purposes the FX differences are part of the general tax base; this means that an FX loss is deductible or an FX gain is taxable irrespective of the expense to which they relate.¹ This does not apply to items that are valued at fair value where the FX difference becomes part of the valuation and thus follows also for tax purposes the treatment of the original item that gave rise to the FX difference.

2. Accounting principles and legislation

The accounting principles govern the recognition of income and loss also for FX denominated transactions. Therefore the accounting legislation and standards are of ultimate importance in this respect.

The Czech Accounting Act was adopted in the year 1992. Since 1992 there have been a number of changes that radically altered the Czech accounting system. The difference can be best illustrated by the following idea. During the last discussions about the separation of the tax system from dependence on accounting legislation it was suggested that a separate system of fiscal accounting was used. In search of a simple and effective system of fiscal accounting that would be separated from the influence of International Financial Reporting Standards (IFRS) and mark-to-market distortions the suggestion was just to copy the original accounting legislation of 1992.

The Czech accounting system is aligned with IFRS; however, there are still significant differences. The most significant differences persist in inconsistency of measurement bases and application of the historic (acquisition) costs and fair value.² The Czech accounting legislation requires certain taxpayers – issuers of securities listed on regulated markets of an EU Member State in compliance with the Council Regulation 1606/2002 – to prepare their accounting statements in accordance with IFRS/IAS.

However, for tax purposes these taxpayers must still present their profit and loss account according to Czech Accounting Standards (CAS). If there is a difference

¹ Decree D-300 of the Czech Ministry of Finance, comments to §23 of the Czech Income Taxes Act.

² J. Strouhal, “Regulation of Accounting in the Czech Republic”, IRBRP, vol. 3, no. 4, pp. 317–326.

between the way in which a specific transaction would be reported under CAS compared to IFRS/IAS then the taxpayer must be able during tax audit to present a reconciliation of the differences under the relevant standards. This means that the taxpayer needs actually to translate the accounting result under IFRS/IAS to the accounting result under CAS. The fiscal authorities also require under a special administrative measure that these taxpayers keep so-called special evidence for tax purposes which in its content is fully equivalent to accounting records under CAS.

Accounting entities are required to keep books in monetary terms using Czech legal tender, i.e. the Czech crown. No other functional currency is allowed and also it is not allowed to keep books in a different currency and translate only the financial statements into domestic currency using the FX rate as of the balance sheet date.

The CAS do follow in the area of hedging IFRS/IAS and recognize both cash flow and fair value hedging under exactly the same rules as IFRS/IAS. Also the exceptions for recognition of derivatives in the area of forwards and futures where the transaction will be fulfilled through physical delivery are reflected in CAS. The only hedging inconsistent with IAS39 is macro (or portfolio) hedging where CAS do not allow this method. Hedging has the effect that as the accounting income/cost is recognized at realization rather than through mark to market, the same effect is achieved for tax purposes as tax follows the accounting treatment.

2.1. Valuation methods and FX differences

In 2002 CAS adopted the concept of fair value also for corporate taxpayers; in the case of financial institutions the concept was used earlier. The fair value is understood as either the market value or the value determined by a qualified appraiser if the market value is not available. If it cannot be determined by either of the previous two methods then the valuation is to be determined in accordance with special valuation legislation.

The purchase cost is used to value the following items:

- intangible and tangible long-term assets (if purchased);
- inventories (if purchased);
- financial investments including securities;
- derivatives;
- receivables for trading.

The production cost approach is used to value the following items:

- long-term tangible and intangible assets produced in own production;
- inventories produced;
- livestock increase.

The face value is used to value:

- cash and valuables;
- receivables and payables originated by the enterprise.

If assets or liabilities were denominated in foreign currency during acquisition, then their value needs to be translated into Czech crowns using the exchange rate of the Czech National Bank. For receivables and payables, ownership interests, securities, derivatives and valuables if they are denominated in foreign currency,

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accounting entities are required in their accounting also to use the foreign currency amounts. This duty also applies to provisions and reserves, if the assets and payables for which they were created are also denominated in foreign currency.

Exchange differences arising during the accounting period are stated in the aggregate profit/loss account. The following categories of assets and liabilities need to be valued at fair value as of the balance sheet date:

- derivatives;
- securities (excluding securities held to maturity, securities representing financial investments with significant or controlling influence and securities issued by the enterprise);
- receivables held for trading;
- liabilities to repurchase securities;
- assets and liabilities hedged with derivatives that are valued at fair value.

In this case the FX effect becomes part of the valuation of the item and influences the fair value as expressed in Czech crowns. It is not therefore stated specifically in the accounting records as an FX difference but is part of the valuation effect from using fair value.

3. Typical transactions and their reflection under CAS

3.1. Purchase and sale of goods

In computing the purchase price of the goods acquired the goods denominated in foreign currency will be booked using the FX rate from the accounts of the taxpayer. From the time of acquisition, the value of inventories will be stated both for accounting and tax purposes in domestic currency. This means that the FX rate used is a historic one.

The only time when FX effects would be taken into account is a situation at the balance sheet date if the sale value of the goods as determined by mark to market was lower than the original purchase price. In this calculation the FX effect would also play a role. Otherwise the fluctuations of the FX rate would be ignored and not influence further the value of inventories or cost of goods sold for tax purposes.

The FX effect would be measured at the level of liability to pay for the goods purchased and the liability would be revalued at the balance sheet date (if still outstanding) using the current FX rate. The FX difference would then either as loss or profit become part of the general income tax base of the taxpayer.

3.2. Acquisition of depreciable assets

The acquisition cost of an asset is fixed when it is acquired. The payment terms of the transaction do not play any role in accounting for the acquisition once the ownership title passes and the asset is put into use.

The FX effect can also arise at the level of liability to pay for the asset and the liability would be revalued at the balance sheet date (if still outstanding) using the current FX rate. The FX difference would then either as loss or profit become

part of the general income tax base of the taxpayer. It will not influence the acquisition cost of the asset and will not influence the depreciation charges for the asset.

The depreciation will be calculated in Czech crowns from the historical acquisition cost and will not be adjusted for any fluctuation in the FX rate.

The same system is applied to the acquisition of real estate with the exception of land. Land is not subject to depreciation.

3.3. Investment in securities or receivables for trading

Securities held for trading and denominated in foreign currency (unless issued by the enterprise) are valued at fair value. In this case the FX effect becomes part of the valuation of the respective item and influences the fair value as expressed in Czech crowns. It is not therefore stated specifically in the accounting records as an FX difference but is part of the valuation effect from using fair value. The same would apply to receivables denominated in a foreign currency that were held by the enterprise for trading.

For tax purposes the treatment is no different because gains and losses from the valuation are also included in the general tax base and taxed accordingly.

3.4. Financing (borrowing and lending)

In the case of financing debts denominated in a foreign currency, the receivables and liabilities are subject to revaluation at the balance sheet date. The FX difference that arises from this revaluation is booked as part of the profit/loss account and for tax purposes treated as part of the general tax base.

Discounts or premiums for foreign currency denominated loans are treated in the same way as for loans denominated in domestic currency. The taxpayer should in this case use the effective interest rate taking into account the nominal interest rate, discounts and premiums and calculate the appropriate effective interest rate and this should be used to spread the costs of the loans throughout the repayment term for the borrower and the accounting on the side of the lender should mirror this treatment.

If the loans are given between related parties then as part of the transfer pricing requirements the interest rate for the loan will be based on the prevailing interest rate for such currency and adjusted for any risk margins.

3.5. Hedging

As stated previously the concept of hedging is recognized not at the level of tax legislation but rather at the level of accounting legislation. The tax treatment follows the accounting treatment.

CAS follow in the area of hedging IFRS/IAS and recognize both cash flow and fair value hedging under exactly the same rules as IFRS/IAS with the exception of macro (portfolio) hedging.

4. Tax conventions and international double taxation

4.1. Tax conventions and permanent establishments

Tax treaties concluded either by former Czechoslovakia or by the Czech Republic do not specifically address the issue or make allowances for foreign currency exchange rates. In administrative practice the FX gains and losses are seen as an inherent part of business income and are treated as such. Thus *vis-à-vis* treaty countries such income is subject to tax mainly in the case of permanent establishments in the territory of the Czech Republic.

Permanent establishments of foreign taxpayers are one of the exceptions where the taxpayer is not obliged to keep books in accordance with CAS and therefore the unified FX rates as published by the Czech Ministry of Finance will be used to translate the accounting result into Czech crowns and thus enable the establishment of a tax base for the Czech permanent establishment of a foreign taxpayer.

During recent years the Czech Republic in its negotiation policy has preferred the credit method in relation to foreign permanent establishments and branches and thus has raised the question of how to translate their results into the tax base of the Czech taxpayer. The administrative practice allows for translating the results of the accounting of the foreign branch or permanent establishment into the accounting result of the Czech taxpayer from foreign currency through using the exchange rate of the Czech National Bank as of the balance sheet date. However, the accounting needs to be adjusted to be fully compliant with CAS and also to respect the limits stipulated by the Czech Income Taxes Act as to the amount of recognizing depreciable fixed assets and other limits set in Czech crowns.

4.2. Foreign tax credit

In accordance with the Czech Income Taxes Act the Czech Republic will grant relief from double taxation to its taxpayers in accordance with the provisions of the relevant double tax treaty binding the Czech Republic. From the year 2001 the Czech Republic has not granted unilateral tax relief; tax paid in a country with no double tax treaty concluded means that the foreign tax will be treated for Czech tax purposes only as expense and will not be credited. The issue of foreign tax credit was subject to several discussions among fiscal authorities and taxpayers. Two formal results of discussions were issued as so-called discussion topics of the coordination forum of the Chamber of Tax Advisers and the Czech Ministry of Finance.

The first topic was discussed in 1998 where the issue was whether a foreign tax credit should be calculated before application of other tax credits. Other more substantive discussions were held in 2005, where the Czech Ministry of Finance confirmed its view that a necessary condition for crediting tax was that the tax was paid abroad irrespective of the date of payment; a tax credit will also be granted in the situation where difference exists in the timing of the taxation of the income between the countries and confirmed that foreign tax credit takes precedence over research and development credit and should be calculated without regard to the research and development credit available to the taxpayer.