

## 1. Introduction

The tax treatment of real economic losses incurred by Czech taxpayers, to the degree that such losses are fairly reflected in their income statements, is affected first of all by adjustments that all taxpayers are required to make to their accounting results in accordance with Act no. 586/1992 Coll. on Income Tax as amended. The adjustments obviously include both exclusion of certain types of income (mostly income that was taxed at the source by withholding tax), as well as the adding back of certain expenses that are disallowed for income tax purposes. Hence by virtue of the income tax law, an economic loss may translate into a taxable income, and vice versa.

This report focuses on tax losses arising for legal entities rather than for individuals. Although the Czech accounting rules and regulations contain provisions under which Czech taxpayers are required to consolidate their financial statements on the assumption that certain criteria for group consolidation have been satisfied, the tax legislation does not provide for group taxation. Each taxpayer is required to submit separately an annual corporate income tax return.

The statutory accounting procedures require every company to disclose separately profits or losses incurred in carrying out its operating activity, financial activities and extraordinary profits or losses. For corporate tax purposes, however, unless otherwise indicated, the tax base is derived from the total accounting result and includes, for example, both losses and gains arising from the disposal, destruction or writing-off of assets, as well as exchange losses and gains.

## 2. General rules of tax treatment of domestic corporate losses

A tax loss equals the amount by which expenses arising in achieving, securing and maintaining income exceed the income of a taxpayer with the exception of income that is not subject to tax, income exempt from tax and income that is not included in the tax base. The correspondence of income and expenses in regard

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to the time and subject matter with which they are connected in the course of one tax period must be observed.

A tax loss is formally assessed by a tax administrator in the event that the taxpayer submits a supplementary corporate tax return, or if the tax administrator is requested by the taxpayer to issue a tax loss assessment. In general, a tax loss is considered to be assessed automatically as of the date of the deadline for submission of annual corporate tax returns in the amount disclosed in the tax return.

The major types of income that are deducted from the accounting results of a company are as follows:

- dividends or profit shares received from a subsidiary (both domestic and foreign), share of a liquidation balance or a settlement share received by a participant upon termination of its participation in a subsidiary;
- clearance of correcting items and reserves, the creation of which has not been recognized as an expense deductible for corporate tax purposes;
- income arising from a difference between the face value and the acquisition costs of its own shares of a company in the event of a forthcoming decrease of the registered capital;
- dissolution of accruals upon commencement of a company's liquidation, in particular those accruals that will not be charged to the company's profit and loss accounts in the course of the liquidation, etc.

Expenses added back to the corporate tax base include, in particular, the following items:

- the excess of accounting depreciation over the aggregate amount of statutory tax depreciation of tangible and intangible fixed assets;
- the excess amount of the net accounting (residual) value of an asset over the net tax (residual) value of an asset in the case of sale or liquidation of tangible and intangible fixed assets;
- as of 1 January 1998, any capital loss made on disposal of securities must be excluded from the annual tax base of a taxpayer and cannot compensate for operating or extraordinary profits of a company;
- a loss made on disposal of an ownership interest in a limited liability company or in a cooperative, and a loss made on disposal of a bill of exchange or a promissory note, which is recorded as a loss made on disposal of a security, decreased by any accrued interest income included in the tax base in accordance with accounting rules and regulations;
- excess of the accrued value of an option premium over the sale price of the option rights;
- excess of net tax value of a technical improvement to a leased property financed by a lessee upon termination of a lease over the reimbursement paid by the lessor, etc.

## 2.1. Losses carryover

Carrying forward of a tax loss is permitted over seven consecutive tax periods (calendar years) following the tax period, or a part thereof, for which a tax loss was incurred. No further restrictions on the deductibility of the tax loss are

imposed in respect of the amount of the tax loss which is deductible in any of those seven years. There are, however, several exceptions to this general rule.

A joint-stock company that came into existence as a result of a transformation of an investment company or an investment fund cannot use the tax losses incurred in the years 1993 to 1995, when corporate profits were taxed by the withholding tax at the investment companies or investment funds.

A loss arising from disposal of securities can be carried forward for the next three consecutive years, during which it can be used to offset capital gains arising from disposal of securities.

There are no provisions under which a taxpayer would be allowed to carry back any tax losses. Czech income tax law also does not include any special rules regarding carrying forward of losses incurred in the first years after the establishment of a company.

## 2.2. Basket limitations

Losses arising from disposal of securities, including shares, debentures, bonds, and deposit certificates do not offset operating profits of a company but can be utilized against profits made on disposal of the securities over the three-year period as explained above.

## 2.3. Other restrictions

The income tax law does not impose any additional restrictions regarding deductibility of losses arising in connection with insolvency of a taxpayer or regarding, for example, the right of a taxpayer to carry forward losses in the event of a change in the ownership of a loss-making company.

## 2.4. Utilization of a corporate tax loss by participants of a company

There are only two types of company that are fully or partially tax transparent in the Czech Republic. A fully tax transparent entity is a general partnership, which is a legal entity but its partners, each of whom is liable without limitation for any debts and liabilities of the general partnership, are treated separately as individual taxpayers. The partners of a general partnership are thus entitled to use the tax loss arising at a general partnership pro-rata to their participation interest. The relevant portion of a loss can be deducted from the tax base of each partner, and if the tax loss is not fully utilized by the partner it is allowed to be carried forward.

The same treatment applies to the portion of a corporate tax loss incurred by a commandite company.

## 2.5. Utilization of tax losses upon transformation of a company

A significant restriction is imposed by the Income Tax Act on utilization of tax losses in the case of mergers, divisions, transformation or fusions of companies.

The surviving company is entitled to use an accumulated tax loss subject to the rules outlined above. However, a tax loss that arose for a company which has been wound up in connection with a merger, a fusion, a transformation or a division of a company does not transfer to the surviving company and cannot be utilized by the legal successor. This applies both to the accumulated tax losses and to the tax loss established as of the date of the dissolution of a company.

### 3. Cross-border losses

As already noted, Czech taxpayers are taxed strictly on an individual basis. Hence no tax losses incurred by a foreign subsidiary of a Czech company can be used to offset taxable income of the Czech company.

Any foreign tax credits arising on foreign source income can be used in full on the assumption that the credits offset the corporate tax liability assessed for the relevant tax period. Any excess tax credits can then be utilized as a deductible expense in the following tax period. Their utilization may consequently result in an overall tax loss for the company.

Income tax paid outside the Czech Republic is considered as a deductible expense only in respect of income which is included in the tax base and only to the extent that such tax was not credited against the tax liability of the company in the Czech Republic. The amount of a tax credit paid abroad, however, is limited by the amount of the Czech corporate tax due on foreign source income. The excess tax can, therefore, only be used as a corporate expense of the head office in the following year.

#### 3.1. Losses of a foreign branch/permanent establishment

If a double tax treaty provides for the credit method, tax losses of a foreign branch/permanent establishment of a Czech company can compensate for profits of the head office in the Czech Republic subject to adjustments made to the accounting results of the branch in accordance with the Czech Income Tax Act. Any portion of a foreign branch loss not utilized may be deducted in part or in full from the corporate tax base of the Czech head office in the current tax period. If the tax base of the home office is not sufficient, the excess foreign tax loss is carried forward and can be utilized as a standard tax loss in the following seven years.

The foreign corporate tax paid by the branch is recognized as a tax credit against the tax liability of the head office.

The overall limitation method used implies that losses incurred by branches from third countries may hinder a tax credit obtained by a profitable branch in another country.

If a double tax treaty allows exemption of a branch income from tax in the Czech Republic, the loss incurred by the branch cannot be deducted from the head office tax base in the Czech Republic.

A tax loss incurred by a foreign subsidiary is not deductible for the Czech parent company.

The basket limitation relating to losses made on disposal of securities also applies to losses arising from disposal of foreign securities.

Czech income tax law does not contain any provision under which losses in a head office registered outside the Czech Republic could be deducted from profits of a branch established in the Czech Republic.

### 4. Conclusion

In summary, a real economic loss is only rarely identical with the tax loss that can be utilized by a taxpayer. The reason is that each taxpayer is required to adjust the accounting results in accordance with the Corporate Income Tax Act and, secondly, that restrictions have been introduced to limit deductibility of certain losses or tax credits.

There appear to be two major underlying reasons. The first one is the case of administration of tax liability, which is the reason why group taxation has not been introduced. The second reason might be the fact that the Czech economy is in a transitional period in which the tax losses arising in various companies are affected to some extent by significant changes in the legal and tax regulatory environment. A continuous evolution of the statutory conditions and requirements in this transitional phase therefore appears to justify a rather conservative approach of the tax authorities towards utilization of past tax losses.

### Résumé

Le présent rapport analyse le traitement fiscal des pertes économiques effectives réalisées aux termes de la législation de la République tchèque. La première partie du rapport résume les règles générales régissant le traitement fiscal des pertes des sociétés nationales. En l'occurrence, une perte fiscale est régie par deux facteurs déterminants. En premier lieu, certains types de revenus sont déduits des résultats comptables d'une société et certaines dépenses sont incorporées dans la base de l'impôt sur les sociétés. Aux termes du dernier amendement à la loi sur l'impôt sur le revenu entré en vigueur à compter du 1er janvier 1998, une perte en capital réalisée sur la cession de valeurs, une perte encourue sur la cession de participations dans une société ou une coopérative à responsabilité limitée, et la valeur acquise d'une opération à prime au-delà de la valeur vénale des droits d'option ne sont pas prises en considération aux fins de l'impôt sur le revenu. Le résultat de ces déductions et additions est qu'une perte économique effective peut être imputée sur un revenu imposable et vice-versa.

Le rapport traite également d'autres questions liées à la détermination et au traitement d'une perte fiscale, telles que les conditions dans lesquelles une perte fiscale peut être reportée à nouveau ou reportée à un exercice antérieur, les limitations à un seul "panier" en ce qui concerne la cession de valeurs, l'utilisation d'une perte fiscale par les participants à

une société de personnes générale, et le traitement des pertes fiscales dans le cas de fusions et d'acquisitions.

La deuxième partie du rapport examine le traitement fiscal des pertes transfrontalières. La question de l'applicabilité de pertes fiscales ou de crédits d'impôt étrangers à la société nationale est examinée par rapport à une filiale étrangère ou à une succursale étrangère, ainsi qu'à un établissement stable d'une société tchèque. Le rapport passe en revue non seulement les dispositions de la loi tchèque sur l'impôt sur le revenu, mais aussi les incidences éventuelles que les conventions de double imposition peuvent avoir sur ce traitement fiscal.

Finalement, le rapport examine les raisons sous-jacentes pour lesquelles une perte économique effective n'est que rarement identique à la perte fiscale qui en résulte. L'une des raisons de cette divergence est l'absence d'une disposition concernant l'imposition de groupe dans la législation fiscale tchèque. La seconde raison est que la transition en cours de l'économie tchèque, l'évolution constante du contexte législatif et de la réglementation fiscale, et les changements importants qui en résultent semblent justifier l'approche prudente des autorités fiscales en ce qui concerne l'utilisation des pertes fiscales antérieures.

#### Zusammenfassung

Dieser Bericht untersucht die steuerliche Behandlung echter wirtschaftlicher Verluste im Recht der tschechischen Republik. Der erste Abschnitt des Berichts enthält eine Zusammenfassung der allgemeinen Regeln für die steuerliche Behandlung von Inlandsverlusten bei Körperschaften. Bei steuerlichen Verlusten spielen in diesen Fällen zwei wesentliche Bestimmungsfaktoren eine Rolle. Vor allem werden von den rechnerischen Betriebsergebnissen des Unternehmens bestimmte Arten von Einkünften abgezogen, während bestimmte Kostenelemente der Bemessungsgrundlage wieder zugeschlagen werden. Aufgrund einer neuesten Änderung des Einkommensteuergesetzes, die am 1. Januar 1998 in Kraft tritt, sind Kapitalverluste bei Wertpapierverkauf, Verluste bei der Veräußerung von Beteiligungen an Gesellschaften mit beschränkter Haftung und an Genossenschaften sowie der kumulative Wert von Optionsprämien, der den Verkaufswert der Optionsrechte überschreitet, von der Einkommensteuerveranlagung ausgenommen. Ergebnis dieser Abzüge und Zuschläge ist, dass der reale wirtschaftliche Verlust sich im steuerbaren Einkommen niederschlagen kann.

Gegenstand des Berichts sind auch andere Fragen im Zusammenhang mit der Bestimmung und Behandlung steuerlicher Verluste, wie zum Beispiel die Voraussetzungen des steuerlichen Verlustvor- und rücktrags auf andere Veranlagungsperioden, kategorielle Beschränkungen (*basket limitations*) beim Verkauf von Wertpapieren, die Einbringung steuerlicher Verluste in Personengesellschaften sowie die Behandlung steuerlicher Verluste bei Fusionen und Akquisitionen.

Der zweite Abschnitt des Berichts behandelt die Steuerpraxis bei grenzübergreifenden Verlusten. Die Frage der Anrechnungsfähigkeit steuerlicher Verluste oder Gutschriften im Ausland bei der Veranlagung der Muttergesellschaft wird erörtert sowohl für den Fall einer ausländischen Tochtergesellschaft oder Zweigniederlassung als auch für den einer ständigen Betriebsstätte eines tschechischen Unternehmens. Der Bericht berücksichtigt nicht nur die Bestimmungen des tschechischen Einkommensteuergesetzes, sondern auch die möglichen Auswirkungen von Doppelbesteuerungsabkommen auf die steuerliche Behandlung.

Abschliessend untersucht der Bericht, warum ein realer wirtschaftlicher Verlust nur selten dem resultierenden steuerlichen Verlust entspricht. Einer der Gründe ist das Fehlen einer Bestimmung über die Gruppenbesteuerung in der tschechischen Steuergesetzgebung. Ein zweiter Grund liegt darin, dass der noch nicht abgeschlossene Umstellungsprozess der tschechischen Wirtschaft, die anhaltende Evolution des rechtlichen und steuerrechtlichen Umfelds und die sich daraus ergebenden erheblichen Veränderungen eine Rechtfertigung dafür sein dürften, dass die Steuerverwaltung bei der Anrechnung steuerlicher Verluste der Vergangenheit eine konservative Haltung einnimmt.

#### Resumen

Esta ponencia analiza el tratamiento fiscal de las pérdidas económicas reales registradas a tenor de la legislación de la República Checa. La primera parte de la ponencia resume las normas generales del tratamiento fiscal de las pérdidas de sociedades nacionales. En este caso, la pérdida fiscal se rige por dos factores determinantes. En primer lugar, ciertos tipos de rentas son deducibles de los resultados contables de una sociedad y determinados gastos se integran en la base del impuesto sobre sociedades. Según la última enmienda de la Ley del Impuesto sobre la renta que entró en vigor el 1 de enero de 1998, no se consideran a efectos de este impuesto las pérdidas de capital por cesión de valores, cesión de participaciones en una sociedad o una cooperativa de responsabilidad limitada y el valor adquirido de una operación con prima. El resultado de estas sumas y deducciones es que una pérdida económica real puede ser imputada a la renta gravable y viceversa.

La ponencia trata también de otras cuestiones relativas a la determinación y tratamiento de las pérdidas fiscales, tales como las condiciones en que puede ser saldada a cuenta nueva o arrastradas a un ejercicio anterior, las limitaciones a una sola "cesta" en lo que se refiere a la cesión de valores, su utilización por los participantes de una sociedad de personas general, así como su tratamiento en caso de fusión y adquisición.

La segunda parte de la ponencia examina el tratamiento fiscal de las pérdidas transfronterizas. El tema de la aplicabilidad de pérdidas fiscales o de créditos de impuesto extranjero a la sociedad nacional se examina en relación con una filial o sucursal extranjera, así como con el establecimiento permanente de una sociedad checa. La ponencia estudia no sólo las disposiciones legales cheques del impuesto sobre la renta, sino también las posibles incidencias de los convenios de doble imposición sobre este tratamiento fiscal.

Por último, la ponencia examina las razones subyacentes que dan lugar a que una pérdida económica real sea en muy escasas ocasiones idéntica a la pérdida fiscal resultante, entre las que destaca la carencia de disposiciones sobre imposición de grupo en la legislación tributaria checa. Una segunda razón es que la actual transición de la economía checa, la evolución constante del contexto legislativo y la reglamentación fiscal, con los importantes cambios resultantes, parecen justificar un enfoque prudente de las autoridades tributarias en el tema de la utilización de pérdidas fiscales anteriores.