

Taxation of controlled foreign company (CFC) pursuant to ATAD

10th June 2020

The amendment to the Income Taxes Act, transposing to the national law the EU Anti-Tax Avoidance Directive (ATAD), has been in effect since 1 April 2019, with the exception of the provisions governing exit tax and hybrid mismatches applicable from 1 January 2020.

In simple terms, the taxation of controlled foreign companies ("CFC rules") means immediate tax imposed on passive income generated in jurisdictions with tax significantly lower than that in the Czech Republic.

A controlled foreign company ("CFC") is a corporate income tax payer that is a Czech tax non-resident having "included income" where the following conditions are met:

- ▶ The CFC does not carry on a substantive economic activity. According to the explanatory memorandum, this condition seeks to limit the application of these rules to only "shell companies", i.e. entities that only serve to hold assets generating passive income. If, however, the company carries on an actual active activity (but not only marginally) supported by staff, premises, equipment and other assets, it may be assumed to carry on a substantive economic activity. The assessment will always depend on the specific facts and circumstances.
- ▶ The foreign income tax (or similar tax) of the CFC is lower than one half of the income tax that would be assessed in the Czech Republic under the applicable Czech tax regulations. Pursuant to the explanatory memorandum, the comparison should consider the tax liability arising from total income (rather than the included income only).
- ▶ The Czech tax resident (corporate income tax payer) holds a direct or indirect participation of more than 50 percent of the voting rights, or registered capital, or is entitled to receive more than 50 percent of the profits of the entity (the criterion of voting rights and the right to profits only applies if the Czech tax resident also owns, directly or indirectly, a share in the registered capital). Alternatively, the Czech tax resident has a foreign permanent establishment the profits of which are exempt from tax in the Czech Republic pursuant to the relevant double tax treaty.

The included income comprises the following income of the CFC: (i) borrowing income, (ii) royalties, (iii) dividends, (iv) income from the sale of shares, (v) income from financial leases, (vi) income from insurance, banking or other financial activities, (vii) income from the sale of goods and services purchased from and sold to associated entities,¹ with little or no added economic value, (viii) income from the sale of goods or services to an associated entity that predominantly engages in the purchase of goods and services from associated entities and the sale of those goods and services to associated entities, with little or no added economic value.

¹ Associated entities mean related entities through capital and entities where one entity is entitled to receive 25% or more of the profits of the other entity.

If the CFC meets the above conditions, the income from the activities of the company and the disposal of its assets, giving rise to the included income, is attributed to the Czech controlling company and is deemed to be realized directly by the controlling company in the Czech Republic. The volume of the attributed activity should generally be determined in proportion to the (direct or indirect) share in the registered capital. The foreign tax on the included income paid by the CFC can be (proportionately) deducted from the Czech tax. Upon the sale of the CFC, the income from the sale should not be subject to tax (up to the amount of retained earnings taxed according to CFC rules).

The Czech legislation is rather succinct and will certainly give rise to significant interpretation and calculation challenges.

We have already informed you about [the rules governing the limitation of tax deductibility of financial expenses](#) and [the rules governing transfer of property without change of ownership \(exit tax\)](#). In the next tax alert, we will describe the basic parameters of hybrid mismatches.



Karel Hronek

karel.hronek@cz.ey.com

+420 731 627 065