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WITHHOLDING TAX EXEMPTION OF EUROBONDS PROPOSED TO BE ABOLISHED

The Czech Ministry of Finance published a draft bill amending the tax treatment of interest income from bonds in the Czech Income Taxes Act with the proposed effective date from 2021. The most substantial change with a potentially large impact on the market practice relates to the tax treatment applicable to bonds issued by Czech tax residents outside the Czech Republic (customarily referred to as Eurobonds, although they can be denominated in any currency).

THE CURRENT TAX TREATMENT

Since the 1990s, interest income from Eurobonds has been exempt from the Czech withholding tax in order to promote raising capital on the international capital markets by Czech issuers and to increase their competitiveness. Consequently, Czech tax non-resident bondholders have been fully exempt from Czech taxation of interest income from the Eurobonds, while Czech tax resident bondholders have been obliged to self-declare interest income from the Eurobonds in their annual Czech income tax returns.

Therefore, for many years, Czech issuers were not obliged to collect information regarding the tax residency status of their bondholders for withholding tax purposes which is administratively demanding especially in case of large bond issues and normally requires the assistance of administrators/paying agents. Nevertheless, as from April 2019, a new notification duty has been imposed under which Czech issuers are obliged to report to the Czech tax authority tax exempt interest income paid to Czech tax non-residents if this income exceeded CZK 100,000 per a single recipient in any given month. The notifications need to be filed by the end of the month following the month of the interest payment, unless such notification duty has been waived by the Czech tax authority with respect to the relevant bond issue on the basis of a reasoned application filed by the issuer.

According to grandfathering provisions proposed in the new bill, Eurobonds issued until the end of 2020 would remain subject to the current favourable tax treatment (i.e. full and automatic Czech withholding tax exemption).

THE PROPOSED NEW TAX TREATMENT

The current tax treatment is proposed to be abolished as of January 2021 and Eurobonds will thus be subject to the same tax treatment as domestic bonds issued in the Czech Republic, i.e. no automatic withholding tax exemption will be available under Czech tax law. Therefore, the issuer would need to identify the tax residency country of each bondholder in order to apply the relevant Double Taxation Treaty concluded between the Czech Republic and the tax residency country of the bondholder which may protect the bondholder from the Czech withholding tax imposed on the interest income.

Under the current proposal, the new Czech withholding tax treatment will differ for coupon bearing bonds and zero-coupon bonds:

i. in case of ***coupon bearing bonds***, interest income in the form of a periodic coupon would be subject to the Czech withholding tax (if not exempted under a Double Taxation Treaty applicable to a respective bondholder);

ii. income from bonds issued at a discount (***zero-coupon bonds***) would not be subject to the Czech withholding tax. Instead, holders of zero-coupon bonds would be obliged to self-declare their income (represented by the difference between the repaid face value and the acquisition price) in their annual Czech income tax return. However, in case of bondholders who are not tax resident in an EU or EEA country, the issuer would generally be obliged to withhold a 1% tax security from the face value at the maturity date of the zero-coupon bond. This tax security withholding could be set-off by the bondholder as an advance payment in its tax return filed as per the above. Again, this tax security withholding could be exempted under a Double Taxation Treaty applicable to a particular bondholder.

Although Czech issuers would need to collect tax residency information from all bondholders in both of the above-mentioned cases, zero-coupon bonds seem to be less burdensome as this collection could be done only once, at the maturity (for the purpose of the tax security withholding), while in case of coupon bearing bonds, the collection would need to be performed prior to the payment of each periodic coupon (for the purpose of the withholding tax).

On the other hand, the notification duty is proposed to be slightly relaxed in that the interest income of a Czech tax non-resident bondholder, if exempt under the applicable Double Taxation Treaty, would be reportable to the Czech tax authority only if exceeding CZK 300,000 per bondholder in a given calendar month. Furthermore, the notifications would be reported only annually (by 31 January of the following year), not by the end of the month following each month of the interest payment.

The proposed bill is still in the external consultation procedures before submission to the parliament. If the proposed bill becomes effective, besides setting up the procedures for the collection of tax residency information of bondholders, Czech issuers of Eurobonds (and investors into such Eurobonds) should carefully review the wording of tax gross-up clauses (i.e. clauses providing for an increase of the gross amount of payments to bondholders to reflect applicable tax to be withheld by the issuer from such payments). These gross-up clauses are contained in standard terms and conditions of the Eurobonds issued on the international capital markets and they will gain new relevance for Czech issuers and investors to Eurobonds as well.

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