

Taxpayer Can Deduct Interest Expenses on Loans, Court Says

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Taxpayer Can Deduct Interest Expenses on Loans, Court Says

The Czech Supreme Administrative Court has issued an important decision¹ confirming that a taxpayer is entitled to a tax deduction for interest expenses related to loans used to finance dividend distributions and distributions of other equity.

The deductibility of those costs has been debated in the Czech Republic for some time. In the past, the Ministry of Finance had argued that such interest expenses are not deductible because they are not incurred in order to generate, secure, or maintain taxable income.

In its March 25 decision, the court examined whether the interest expenses qualify as expenses incurred in order to generate, secure, or maintain taxable income under the general rule in the Czech Income Tax Act.² The interest deductions at issue amounted to approximately CZK 245 million (approximately €9.7 million or \$13.2 million).

According to the general reasoning of the court, incurred expenses do not always need to be immediately reflected in the income of a taxpayer. In other words, a direct correlation between costs and revenues is not necessary to meet the requirements of the general rule. However, to reduce the tax base, expenses must be incurred in order to make a profit and there must also be a direct and immediate relationship between those costs and expected revenues. This direct and immediate relationship implies that without incurring the expenses, a company would not have gained or even had a chance to gain the expected revenues. It is always necessary to consider whether an actually incurred expense will generate income (profit), ensure such income in the future, or at least help maintain revenues achieved as a result of previous activity

conducted by a company, the court said. All of those economic activities correspond to the spirit and objectives of the ITA, it added.

The court also analyzed the nature of dividends distributions. Dividends are payable within three months after a resolution on a distribution of profit has been adopted in a general meeting (unless the statutes or another resolution by the board of directors stipulates otherwise); therefore, the moment when profit originates is different from the moment when the profit is to be paid to the shareholders. However, the current legislation does not specify how to deal with profit until the resolution on a distribution of profit (or other relevant resolution) is adopted in a general meeting.

A joint stock company is not required to keep sufficient liquidity to cover its dividend payments to shareholders, so the company's funds can be used in other ways (such as for investments or to finance operating costs). It is up to the joint stock company to decide whether to use its own resources or foreign resources (such as loans) to cover its dividend distributions.

If a company decides to retain its revenues to cover later dividend distributions, it may have to finance its operations or investment expenses using foreign resources. This could result in additional costs (particularly in the form of loan interest) if a company does not curtail the planned expenditure, which would reduce its expected revenues. However, if a company decides to take out loans to finance later dividend distributions, the funds that would otherwise be allocated for those purposes may be used to finance its operations and investment costs in order to generate, secure, and maintain taxable income.

A company choosing the latter business strategy should not receive less favorable tax treatment than a company choosing the first business strategy, the court said. In other words, there is no reason for interest on a loan meant to finance operations and investment costs to be tax deductible while interest on a loan meant to cover dividend payments is not tax deductible. It can therefore be concluded that interest and other inevitable costs related to a loan used to finance

¹Ref. No. 5 Afs 25/2009-98.

²Act No. 586/1992 Coll., on Income Taxes.

a dividend distribution have the necessary direct and immediate relationship to the expected taxable income and are therefore tax deductible. In any case, a payment of dividends motivates shareholders to invest their own funds in a company, and without such funds, the company would not be able to operate.

As a supportive argument, the court also referred to similar decisions by non-Czech courts, including those in Israel, Austria, and especially Poland. ◆

- ◆ *Pavel Fekar and Michaela Drábková, Baker & McKenzie, Prague*