SPECIAL FACTORS FOR BUSINESS OPERATIONS IN CZECHOSLOVAKIA

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INTRODUCTION

This paper is designed to be a short guide to the privatization process in Czechoslovakia as well as to the structuring of investments in this part of the world. I will first outline the current state of affairs in the Czechoslovakian privatization program, and then go on to explain some of the more significant reasons for setting up regional headquarters. I will then briefly describe the structuring of regional management and will conclude by dealing with some tax issues for regional companies.

The purpose of this guide is not to be comprehensive, rather it is to be seen as an introduction. I gather that many of the topics touched upon will be examined by other participants from Czechoslovakia in much greater detail.

Let me start with a joke. Two Czechoslovakian friends meet in Prague. The first one complains about being unemployed. The other replies: "Why don't you set up a business? You might become a director."

Fortunately, the number of unemployed has remained very low. It is still below 3% in the Czech Republic, while the unemployment level in the Slovak Republic has been a little higher. On the other hand, the number of new companies in Czechoslovakia has increased so dramatically that sometimes the number of newly established companies seems to be larger than the entire population. In any event, this development is in my opinion a positive sign of awakening from forty years of lethargy.

PRIVATIZATION

It is worth noting at the outset that almost all industrial objects, buildings, farm land and areas used for forestry purposes were previously owned by the state. In view of this extraordinary concentration of national property in the hands of the state, it is obvious how formidable the task is to transfer state property into private ownership.

FORMS OF PRIVATIZATION

There are two basic forms of privatization, called minor and major privatization. Both forms started in 1991. The former concerns small businesses, such as hotels, restaurants, shops, production plants and similar objects, which form part of a state company or of a different entity owned by the state, and which can be operated as independent business units even after their separation from the parent company. Some 130,000 entities were reported to be affected.

MINOR PPRIVATIZATION THROUGH PUBLIC AUCTIONS

The transfer of property into private ownership is effected through public auctions. Title to property can be transferred only to natural persons who are presently, or who were at any time after February 25, 1948, Czechoslovakian citizens, or to legal entities, the shareholders of which are exclusively composed of resident natural persons. If the entity is not sold at the first auction, it may be sold at a second auction. At the second auction foreign natural persons or foreign legal entities consisting of such natural persons also may participate.

The auctions are prepared by local privatization commissions, the formation of which is regulated by the Czech and/or Slovak government.

MAJOR PRIVATIZATION

The major privatization program applies to state companies, state financial institutions, state insurance companies, state foreign trade companies, and other state-owned economic entities as well as to the shareholdings such entities and/or the state have in third party legal entities. Assets may be acquired by both resident and non-resident natural persons and legal entities. At this point I would like to turn to how the privatization program works in practice when a foreign investor wishes to acquire a state-owned company or part thereof.

PRIVATIZATION PLAN

Since the law merely stipulates that a privatization plan must be worked out in each case by the enterprise to be privatized, the best approach for a foreign investor was to contact the management of the state enterprise or company in question and to jointly develop a common privatization project that would incorporate the wishes and expectations of the foreign investor. While the privatization plan was submitted to the appropriate authorities only in the name of the enterprise or company to be privatized and not under the name of the foreign investor jointly, future cooperation with the foreign investor was nevertheless an integral part of the plan. If, however, a part of the state enterprise or company was to be privatized through a direct sale to a Czech or foreign investor, the plan was also submitted to the Ministry for Privatization, but it was further subject to approval of a respective governmental Economic Council. The purpose of this approval process was to ensure greater impartiality for the benefit of other competitors.

If the foreign investor was not able to achieve a successful common privatization plan, it was entitled to file its own competitive privatization plan based upon economic reports and financial data which the management was obliged by law to supply. It is fully understandable that foreign competitors, as well as even domestic competitors, were not placed in the same position as the original enterprise or company. Moreover, impartiality of the decisions was also doubtful in some cases.

NEW GOVERNMENTAL RULES

Therefore, the Czech government has approved new rules to streamline a process which, in the past, has occasionally become bogged down by disputes. The main changes are as follows:

The Economic Council will be replaced by a governmental privatization commission, to be supervised by the privatization minister and staffed by members of four ministries. This commission will evaluate disputes between project authors and the Ministry of Privatization. The ministers shall be entitled to object to projects, which have been approved by the Ministry of Privatization, within ten days.

Enterprises with a book value of less than 50 million crowns will be asked to choose one of three methods for privatization:

open bid, public auction, or voucher privatization. If voucher privatization is chosen, the enterprise must have a book value of at least 20 million crowns.

In public auctions, the highest price obtainable will be decisive. At least the book value for the enterprise or company must be offered.

The aforementioned rules should, in my opinion, simplify the procedure and make it more transparent for foreign investors.

ACQUISITION OF REAL PROPERTY

It may also be of interest to you that according to the Czechoslovakian Foreign Exchange Act, foreigners are not entitled to acquire real property except for some minor exceptions. They may, however, acquire real property through the privatization process. On the other hand, domestic companies wholly owned by foreign parties are not subject to the Foreign Exchange Act and may acquire such property.

REGIONAL HEADQUARTERS

From a historical as well as geographical point of view, Czechoslovakia might become an advantageous venue for establishing regional headquarters. Thinking back to the Austro-Hungarian monarchy, it is quite understandable why the new Czechoslovakian and Hungarian legislation is again based mainly upon the Austrian legislation. In addition, foreign investors will certainly want to take advantage of the experience gained by Czechoslovakian experts in trading with Eastern European countries. I am convinced that the development of markets in

Eastern Europe will result in the establishment of regional headquarters in Czechoslovakia or, if Czechoslovakia is divided into two separate republics, which seems to be extremely probable, immediately in the Czech and later also in the Slovak Republic. Prague as a capital will play an important role in this context.

Summarizing the reasons for regional establishing headquarters in Czechoslovakia, there are the following factors:

a) market knowledge
b) similar language (Polish, Russian)
c) lower labor costs
d) new legislation, based mainly upon the Austrian, but also upon German and French legislation
e) historical reasons (market economy before 1948)
f) international Conventions on Supporting and Protection of Investments in Czechoslovakia, concluded with 16 countries, as well as the Conventions for the Avoidance of Double Taxation with respect to Taxes on Income and Capital, concluded with 20 countries
g) relatively low inflation rate
h) stable rate of exchange

<u>STRUCTURING OF REGIONAL MANAGEMENT</u>

As far as the structuring of regional management is concerned, I suggest utilizing both foreign and Czechoslovakian managers. Working and residence permits for foreigners must be obtained. The staff can be hired in Czechoslovakia, but there may be a problem in finding qualified employees with the required skills. Therefore, foreign companies often send their employees to training courses.

It should also be pointed out that there are no legal requirements regarding the nationality of managers. This means that a company is allowed to have foreign managers only provided that they have the abovementioned permits.

TAX STRUCTURE FOR REGIONAL COMPANIES

Effective as of January 1, 1993 a unified tax system in Czechoslovakia will be introduced. The new tax system is based upon the principles of the tax systems applied in the member states of the European Community. The reason for seeking consistency with tax systems in these countries is to eliminate any administrative barriers to the entry of Czechoslovakia into all European integration processes.

The tax system in Czechoslovakia shall include the following:

1. a Value Added Tax, including a tax on imported items;
2. Consumer taxes, namely:
   a) tax on hydrocarbon fuels and oil,
   b) tax on liquors and distillates,
   c) beer tax,
   d) wine tax,
   e) tobacco and tobacco products tax;
3. income taxes:
   a) personal income tax for all natural persons,
   b) corporate income tax applying to all legal entities;
4. a real estate tax;
5. a road tax;
6. an inheritance tax and gift tax;
7. a real estate transfer tax;
8. an environmental protection tax.

Taxation of legal entities will be subject to a tax rate of 45% of the tax base. This tax rate can be increased up to 5 percentage points by the respective laws of either the Czech or Slovak Republic. Furthermore, some special tax rates will apply to dividends, interest, industrial rights, deposits etc.

CONCLUSION

I have, perhaps, spoken for too long on the present changes in Czechoslovakia. However, this has been an attempt to pass on, in as short a time as possible, adequate detail about a subject which is becoming of increasing importance to your clients as foreign investors intending to start business activities in Central and Eastern Europe.