

# Legal and Corporate Ownership Structure

## Introduction

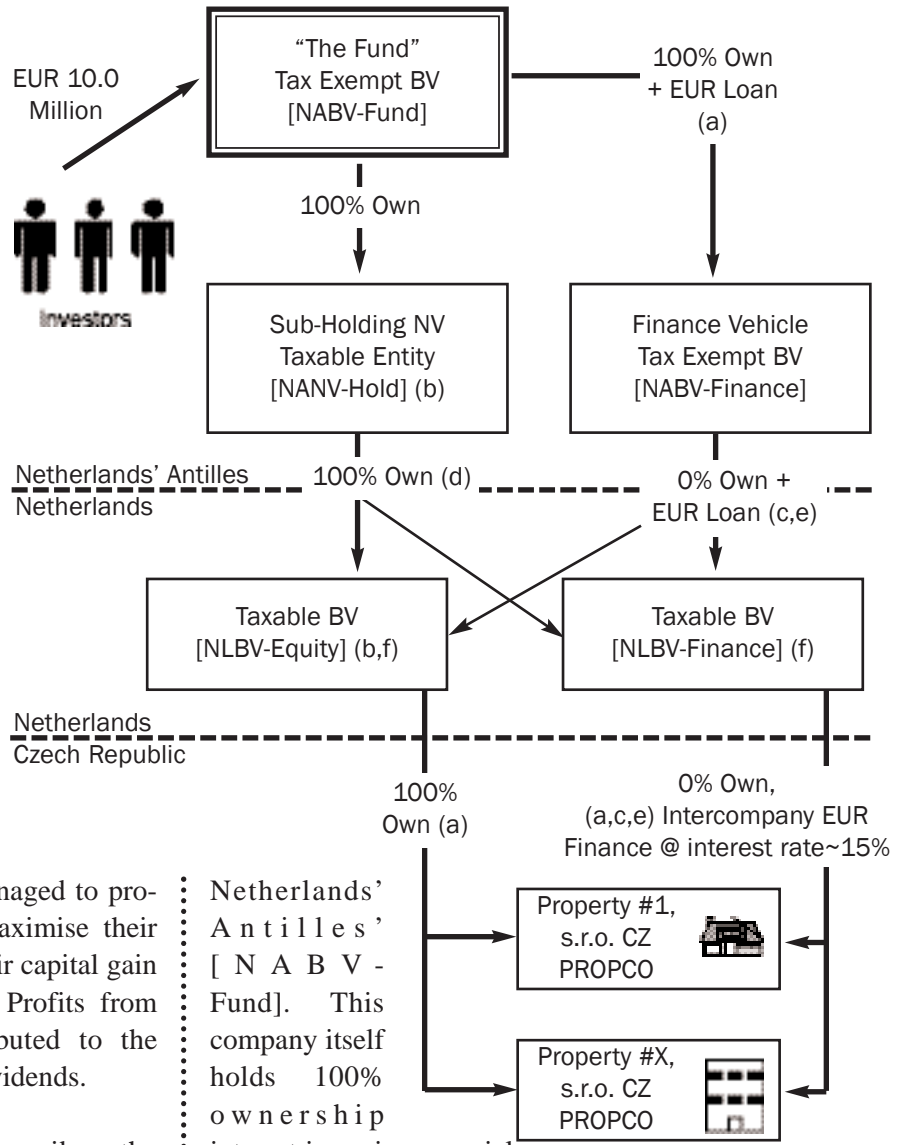
This document relates specifically to the creation of a Real Estate Fund referred to as the Property In Prague Fund-I [PIPF]. This Fund is capitalizing with EUR 10.0 million to invest into residential properties in the Czech Republic that require light refurbishment or are ready to lease out for income. The investment criteria diversifies the portfolio of properties by Condition, Location, Price Level, Age, Size, Construction Quality, Building Type, Potential for Capital Growth and Cash Flow from Rental Yields.

These properties are subsequently managed to produce rental income, developed to maximise their value and later harvested to realise their capital gain potentials when the timing is right. Profits from these activities are routinely distributed to the Fund's Shareholders in the form of dividends.

This document describes the legal and corporate structuring mechanisms in place to minimise the overall exposure of the original incomes generated by the Fund's real estate assets to various types of taxation from various countries; namely the Netherlands' Antilles, the Netherlands and the Czech Republic.

## Basic outline of the Structure

All investment share capital is put into a mutual fund holding company located in the



Netherlands' Antilles' [NABV-Fund]. This company itself holds 100% ownership interest in various special purpose companies that function to legally minimise the tax burden on the income ultimately derived from rents and capital gains from the underlying real estate investments of the Fund.

This structure works by minimising the tax burden on dividend distributions and interest payments arising from income generated by properties owned by the special purpose property holding companies incorporated in the Czech Republic (PROPCOs).

Tax minimisation is achieved through this structure because of the various tax treaties that exist between the Netherlands' Antilles and the Netherlands, and, most importantly, between the Czech Republic and the Netherlands. The Fund's use of this structure is somewhat unique to the Czech Republic, and is not

### Notes:

- (a) 0% WT on Dividends
- (b) 0% CIT on Dividend income because of Participation Exemption on Dividends and Capital Gains.
- (c) 0% WT on Interest
- (d) 8.3% WT on Dividends
- (e) Requires spread of 1/10 - 3/10% between the interest rates on loans out and in.
- (f) Subject to 1x capital tax of 0.55% of contributed equity capital. Hence, majority of capital is structured as debt.

WT: Withholding Tax  
 CIT: Corporate Income Tax  
 CGT: Capital Gains Tax

necessarily optimal or even suitable for use in other countries.

The majority of profits are distributed out of the Czech Republic in the form of interest payments. This is much more efficient than distributing via straight dividends in that no official declarations of dividends must be filed and the interest can be written against the local PROPCO's taxable income base.

### Why All these Companies?

Outside of the Czech Republic, there are effectively five separate companies in this structure: three in the Netherlands' Antilles and two in the Netherlands. The bottom line is that there is no tax treaty between the Netherlands' Antilles and the Czech Republic, but there is a tax treaty between the Netherlands and the Czech Republic and also between the Netherlands and the Netherlands' Antilles. Thus, profits—via dividends and interest payments—are

transferred to a low tax jurisdiction (i.e. the Netherlands' Antilles) and a tax-exempt entity with minimal withholding taxes and maximum use of interest payments to legally reduce the tax base of the income producing PROPCOs in the Czech Republic. This structure is widely used to the extent that it is commonly referred to as the “Dutch Sandwich.”

Referring to the diagram on the front page, the top company, NABV-Fund, is the company from which shares are sold and profits are ultimately distributed to shareholders. The NANV-Hold below it acts as a holding company for the equity in the two subsidiaries in the Netherlands. The NABV-Finance is a special purpose finance company whose purpose is to supply capital to its “cousins” in the Netherlands via intercompany loans. Neither of the finance companies (NABV-Finance or NLBV-Finance) own equity in any subsidiaries, but do supply the majority of capital to the subsidiaries through loans.

### “Thin Capitalisation” Explained

“Thin Capitalisation” is referring to the practice of effectively loaning money to one's self via the use of separate entities owned by the same or closely related party. The most common example is a parent company loaning money to its subsidiary with interest for the purpose of deducting the interest charge from the subsidiary's own tax base. “Thin Capitalisation” rules limit the deductibility of the interest charge as a function of the company's debt/equity ratio.

In the Czech Republic, if debt provided by related parties (Czech or foreign) is more than 4 times the equity base (share capital + premium + retained earnings), the interest from portions of the loans exceeding the 4:1 ratio are automatically considered to be dividends; hence eliminating the use of interest to reduce the tax base and exposing the payments to potential withholding taxes. However, this rule does not apply in the year of constitution of the company receiving the loan and the 3 following years. Incidentally, interest paid on loans provided by non-related entities are not concerned by these rules.

The “related party” is a person or company who owns directly or indirectly more than 25% share in the equity capital or who has more than a 25% share in voting rights. The “equity” consists of the registered capital, all kinds of funds, reserves and accumulated profit or loss.

NLBV-Equity in the Netherlands is the key holding company for the equity in all of the Czech PROPCO subsidiaries. NLBV-Finance acts as the primary finance vehicle directly supplying loans to the Czech PROPCO subsidiaries. It is important to note that the two Netherlands companies are unrelated at the level of the Netherlands.

All companies in this structure ultimately consolidate 100% into the top level company that the shareholders own, NABV-Fund. Intercompany loans are of course eliminated in the consolidated accounts and the profits distributed from its subsidiaries, whether by dividend or interest payment, are ultimately distributed to the shareholders.

Starting from the top [NABV-Fund]

The tax-exempt Netherlands' Antilles (Holding) B.V. [NABV-Fund], is incorporated under the name Property In Prague Fund-I, B.V., which is in effect a Mutual Fund. This is the ultimate holding vehicle where the investors' funds are pooled. The core reason for establish-



*The Antilles Flag*

held by this Fund qualify under these rules. Therefore, the Netherlands' Antilles B.V. constitutes an ideal vehicle for Mutual Funds and Portfolio Investments.

The downside is that, due to its tax-exempt status, the Netherlands' Antilles B.V. [NABV-Fund] does not benefit from treaty protection the Netherlands, which exposes the dividends transferred from the Netherlands to 25% withholding tax. Therefore, a subject-to-tax Netherlands' Antilles N.V. is established as a holding vehicle, in order to reduce withholding taxes on dividends levied at source in the Netherlands. .

**The Netherlands' Antilles N.V. Holding Company [NANV-Hold]**

It is necessary to establish an N.V. [NANV-Hold] in the Netherlands' Antilles to receive dividends from the Netherlands B.V.s, NLBV-Equity and NLBV-Finance, because of the fact that NANV-Hold is a company subject to taxes in the Netherlands' Antilles and therefore covered by the tax treaty between the Netherlands and the Netherlands' Antilles which reduces the 25% withholding tax to 8.3%. In contrast, NABV-Fund is a tax-exempt corporation and therefore not covered by the treaty. Consequently, if NABV-Fund. were to receive dividends directly from the Netherlands B.V., then the normal withholding tax rate of 25 % would be applicable in the Netherlands on those dividends.

A taxable holding company in the Netherlands' Antilles (i.e. NANV-Hold) owns the Netherlands B.V.s [NLBV-Equity and NLBV-Finance], due to the following reasons:

1. Under the new fiscal framework for the Kingdom of the Netherlands, withholding taxes on dividends distributed from the Netherlands to the

ing an NABV-Fund as the ultimate holding vehicle is that it is a tax-exempt entity, provided that the company's business object solely is investments in securities, deposits or debt instruments.

The underlying assets

Netherlands' Antilles are reduced from 25% (normal rate in the Netherlands) to 8.3%. There are no withholding taxes on interest payments.

2. In the Netherlands' Antilles, there is a 100% Participation Exemption on the income derived from the Netherlands' Antilles N.V.'s [NANV] Participation in the Netherlands B.V.s [NLBV and NLBV-Finance], i.e. the participation exemption applies to dividends and capital gains (but not interest income). Therefore, in the Netherlands' Antilles, there will be no corporate income taxes on the dividends received by the Netherlands' Antilles N.V. from the Netherlands B.V., nor on the capital gains realized by the Netherlands' Antilles N.V.'s alienation of the shares held in the Netherlands B.V.
3. There are no dividend withholding taxes in the Netherlands Antilles.

**The Netherlands Antilles Finance Company [NABV-Finance]**

In order to minimise the taxable income inside the Netherlands' Antilles, second tax-exempt Netherlands' Antilles B.V. [NABV-Finance] is established to carry out intercompany loan financing activities. NABV-Fund will grant a loan to NABV-Finance in order for it utilize this loan to finance 85% of the capital structure of the Netherlands BVs, NLBV-Equity and NLBV-Finance. NABV-Finance will later receive the interest payments on the loans granted.

The reason for this setup is that interest payments are tax-exempt in the hands of the NABV-Finance, whilst subject to 34.5% corporate income taxes if received directly by the taxable Netherlands' Antilles N.V., NANV-Hold.

*“Curaçao is widely recognized as the birthplace of the Hedge Fund industry.”*

The majority of cash inflows to the Netherlands' Antilles are in the form of interest payments from the finance vehicle in the Netherlands, NLBV-Finance. This method minimises tax burden since there are no withholding taxes on

interest between the Netherlands and the Netherlands' Antilles. Furthermore, the tax-exempt status of NABV-Finance eliminates Corporate profit tax exposure in the Antilles.

Due to the fact that the thin capitalization rules in the Netherlands require a debt-equity ratio of at least 85% to 15% as of the inception of the company, the remaining 15% of the Capital structure of the Netherlands companies will be comprised by equity held by NANV-Hold.

### **The Netherlands BV Holding and Finance Regime [NLBV-Equity and NLBV-Finance]**

One of the most important features of the Netherlands corporate income tax law, is the provision with respect to profits and gains derived by a Netherlands company from its subsidiaries and participations. Unlike most other countries with a favourable tax treatment for holding companies, the Netherlands Corporate Income Tax Act does not distinguish between a holding company and other companies. All companies therefore, whether holding companies or operating companies, may take advantage of the participation exemption (deelnemingsvrijstelling). This means that all income derived from shares, owned in other companies is completely tax exempt from corporate income tax, if certain conditions and criteria are met.

A Netherlands BV Holding Company [NLBV-Equity] is set up to hold the shares in the Corporations established in the Czech Republic (i.e. the PROPCOs), due to the following reasons:

- 1) By virtue of the Double Tax Treaty between Holland and the Czech Republic, the withholding taxes on dividends and interest payments (normally 15%) are reduced to zero;
- 2) A 100% Participation exemption will be applicable on the dividends distributed from the Czech Republic to the Netherlands BV, and on the capital gains realized on the alienation of the shares held by the B.V. in the Czech corporation, provided the following conditions are met:
  - a) The Netherlands' B.V. must hold at least 5% of the capital in the Czech corporation;

- b) The Czech corporation should be subject to taxes in the Czech Republic;
- c) The investment of the Netherlands B.V. should not be a mere passive or portfolio investment. The criteria to assess whether the investment of the Netherlands B.V. is a mere passive or portfolio investment are the following: (i) BUSINESS LINK TEST: The Netherlands B.V. should wield an effective influence on the decision making process of the Czech corporation. (ii) LINK FUNCTION TEST: The business activities of the Netherlands B.V. should be in the same line as the Czech corporation's business activities. (iii) The Netherlands B.V. should hold at least 50 % of the capital of the Czech corporation. If any of these conditions is met, the B.V.'s investment shall not be deemed to be a mere passive investment. Therefore, if the B.V. held at least 50 % of the capital of the Czech corporation, the investment shall not be deemed to be mere passive or portfolio investment.
- 3) In the Netherlands there are no withholding taxes on interest payments to foreign entities outside the Netherlands.

NANV-Hold would distribute only the minimum cash needed to establish the structures of NLBV-Equity and NLBV-Finance. NLBV-Finance receives the majority of its capital in the form of loans from NABV-Finance. NLBV-Equity would receive enough equity capital from its Parent, NANV-Hold to subsequently distribute the minimum equity capital required (CZK 200,000 or ~EUR 6,700) to establish the PROPCO holding company in the Czech Republic.

NLBV-Finance would then loan the remaining funds necessary to purchase the property to the new Czech company established to actually purchase the real estate [PROPCO]. The rental income received by PROPCO would be used to pay off the debt and the interest paid on the debt would reduce the taxable income base of the PROPCO as well as receive the favourable tax benefits within the Netherlands and Netherlands' Antilles combination before flowing out of the structure.

In the Netherlands, interest payments received by the Netherlands BV may be deducted from interest payments made by the Netherlands' BV to the Netherlands Antilles (Finance) BV.

Additionally, a 100% Participation exemption will be applicable in the Netherlands on the income derived by NLBV-Equity's shareholding in the Czech property companies. This effectively eliminates tax exposure in the Netherlands on the dividends and capital gains (but not interest) ultimately resulting from the equity distributions generated by the underlying real estate assets.

In the Netherlands, interest payments made to NABV-Finance in the Netherlands' Antilles may be deducted from interest payments received by the NLBV-Finance from its Czech PROPCO debtors. The resulting difference or spread in the Netherlands needs to range from 1/10% to 3/10% in order for it to be considered by the Netherlands Tax authorities as a spread resulting from a transaction carried out between unrelated parties (at arm's length). That spread will be taxed in the Netherlands at the following tax rates: 29 % on the first 22,000 Euros and 34.5% on anything beyond 22,000 Euros.

Unrelated to profit taxes, but still important is a one-time capital tax of 0.55 % based on the net capital contribution to the Netherlands B.V. (paid in capital plus share premium, if any) will be due. The capital tax must be paid in the Netherlands within one month after the incorporation of the B.V. This is additional reasoning for capitalising the Netherlands companies with debt rather than equity.

## Holdings in the Czech Republic

Every property in the Czech Republic is owned by a special purpose limited liability holding company in the Czech Republic [PROPCO]. A PROPCO may own more than one property each, but in practice the number will probably be no more than five to ten. Each Czech Company [PROPCO] is fully owned by the Holding Company established in the Netherlands, NLBV-Equity, because under the Double Taxation Treaty between the Netherlands and the Czech Republic withholding taxes on dividend distributions and on interest payments are reduced to zero (Article 10.3 and Article 11.1 of the Czech Republic & Netherlands Convention for the

avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital).

Aside from the fact that owning property through a legal entity is the only way for non-Czech citizens to own Czech property, this structure creates the possibility to circumvent the Czech Republic's 5% tax on real estate title transfers and eliminate taxes on gains from the sale of properties (see "Taxation in the Czech Republic").

In the Czech Republic, there are no thin capitalization rules until the third year of a corporations' inception. Consequently, the PROPCO may initially be fully capitalized with debt until the third year of its incorporation. Thereafter, the debt-to-equity ratio should be at least 4 to 1. Hence, as of the third year of incorporation, at least 20% of its capital has to be comprised by equity.

Under current thin capitalization regulations in the Czech Republic, effective for tax years beginning 1 January 1998, the only debt which is subject to thin capitalization is parent company debt or other debt in the direct line of ownership and control. Since the finance vehicle, NLBV-Finance, has no equity interest in the Czech PROPCO and no direct affiliation with PROPCO's parent, NLBV-Equity in the Netherlands, the loan from NLBV-Finance circumvents the "Thin Capitalisation" rules even after the third year since the loan is not made directly from the Parent Company or a company with any equity ownership whatsoever for that matter.

## About The Netherlands' Antilles

Since 1939, the Netherlands' Antilles has acted as an international financial centre, and Curaçao has become one of the preferred locations in the Caribbean for international tax-planning and financial transactions. The Netherlands' Antilles is an autonomous country within the Kingdom of the Netherlands. Its legal system is based on civil law and is similar to the legal structure in the Netherlands. The Netherlands' Antilles is known for its stable political and legal climate, superior business infrastructure and for its flexibility, professionalism and confidentiality. Netherlands' Antilles law does not require statutory provisions with regard to the nationality of registrars, transfer agents, invest-



Martin and is part of Guadeloupe, and its southern portion is named Sint Maarten and is part of the Netherlands' Antilles.

### Location

Located near Central America in the Caribbean, two island groups in the Caribbean Sea - one includes Curacao and Bonaire north of Venezuela; the other is east of the Virgin Islands.

Covering 960 sq. km, the Netherlands' Antilles includes Bonaire, Curacao, Saba, Sint Eustatius, and Sint Maarten (Dutch part of the island of Saint Martin). It has a 10.4 km boarder with one country, Guadeloupe (Saint Martin).

### New Fiscal Framework ("NFR")

In 2001, the Netherlands' Antilles tax regime changed to comply with rules of the Organization for Economic Cooperation and Development (OECD) and the European Union. Both organizations have decided to discourage the use of tax havens and countries that provide preferential treatment to international business. The main objective of the NFR is the repeal of the tax regime for offshore companies, so that the Netherlands' Antilles is no longer characterized as a tax haven or as a country with a tax system aimed at attracting financial activities and other geographically mobile activities which may qualify as harmful tax competition. Another objective of the NFR has been the conclusion of a new Tax Agreement for the Kingdom of the Netherlands in order to establish a more favourable and long lasting tax relationship with the Netherlands. A further objective is to conclude tax treaties with other countries in Europe, Latin America and with the United States.

The implications of this on the Fund should be quite positive since the measure will enhance the image of the Netherlands' Antilles as a place for legitimate business only. Additional tax treaties concluded between other European countries would further increase the flexibility of investing directly from the Netherlands' Antilles without undue tax consequences. This would result in greater transparency for the Fund. Finally, the new rulings clear up the relative uncertainty behind how the taxation laws are to evolve. There do not appear to be any additional changes in the treaty between the Netherlands and the Netherlands' Antilles for the foreseeable future.

ment managers and paying agents, allowing for a great degree of flexibility in the structuring of offshore structures, including mutual funds. This all translates into reduced costs of administration and extra profits for shareholders.

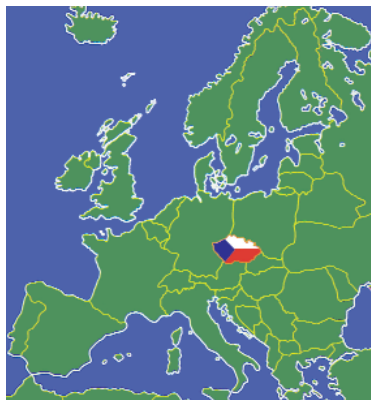
### Birthplace of the Hedge Fund Industry

Curaçao is widely recognized as the birthplace of the Hedge Fund industry. Early Hedge Funds including George Soros' Quantum Funds and Julian Robertson's Jaguar Fund were active in the 60s and chose Curaçao as their domicile of choice. Their selection was based on a long history of service to the international business community that can be traced to the 1930s which resulted in a well developed infrastructure and a ready supply of trained professionals to serve the industry. The success of the jurisdiction is proven by the existence of the headquarters of the market leaders providing fund services catering to the Hedge Fund industry.

### History

Once the centre of the Caribbean slave trade, the island of Curacao was hard hit by the abolition of slavery in 1863. Its prosperity (and that of neighbouring Aruba) was restored in the early 20th century with the construction of oil refineries to service the newly discovered Venezuelan oil fields. The island of Saint Martin is shared with France; its northern portion is named Saint-

# Taxation in the Czech Republic



## General Overview

Czech law stipulates that foreign individuals cannot directly own real estate within the Czech Republic. However, foreign individuals or legal entities can own real estate indirectly by first establishing a simple limited liability company

in the Czech Republic (an “s.r.o.”) that would itself own the underlying real estate asset. The foreign individual or legal entities can own 100% of the Czech Company’s stock.

The following key points are worth highlighting regarding Czech Taxation:

- The type of corporate entity will not normally have a significant effect on the Czech tax liability.
- Withholding tax applies to dividends paid to resident companies and individuals and to non-residents, the latter subject to any reduction under double taxation treaties.
- No distinction is made in the treatment of capital gains and revenue items.
- Losses incurred in one period may be carried forward against profits made in the following seven years.
- Interest paid on loans from foreign borrowers in excess of the maximum permitted debt/equity ratios is re-characterized as a dividend.
- Foreign borrowings must be reported to the Czech National Bank
- Related-party transactions must be at arms-length value.
- The merger of companies with different legal forms (i.e., merger of a limited liability company with a joint stock company) is possible.

- Liquidation distributions are taxable in the Czech Republic.
- Asset purchase results in depreciation; a step-up in basis cost cannot be achieved via a share purchase.
- Tax concessions are available in the Czech Republic under the rules for investment incentives.
- The Czech Republic has treaties closely following the OECD model with many countries. The treaty with the Netherlands is particularly favourable.

## Taxation Issues

### Taxation of the Rental Income

Income from the lease of real estate creates a partial tax base. Real estate property that produces rental income qualifies for depreciation (in general over 30 years) and deduction for interest and finance charges, real estate taxes, repairs, maintenance and certain other types of rental expenses. Interest incurred before the real estate is brought into use has to be capitalised as part of the acquisition cost of the property and may subsequently be depreciated for tax purposes.

The Fund’s structure calls for an intercompany loan structure that aims to bring the net income realized from rent in the Czech Republic close to 0. Thus, income to the fund will come in the form of interest payments to the Dutch entity, which is exempt from withholding taxes.

### Loss carried forward

A tax loss may be deducted from the tax base in no more than seven subsequent taxable periods immediately following the taxable period for which such a tax loss was assessed. Loss carry-back is not possible under Czech law.

### Depreciation

Tangible assets may for tax purposes be depreciated either by the straight-line or accelerated method.

Generally the owner shall for tax purposes determine the method of depreciation for newly acquired assets. The method of depreciation cannot be changed during the depreciation period. In the first year of depreciation, tangible assets are to be classified into one of five depreciation categories, with minimum depreciation periods ranging from four to thirty years. For real estate, the thirty-year period usually applies. Land is excluded from tax depreciation.

Special provisions need to be considered with respect to the tax treatment of “technical improvements” carried out by the lessee on leased premises, in order to avoid disadvantageous tax impacts for both the lessor and the lessee.

For the purposes of this fund it will not always be advantageous to use depreciation at all given that the interest expense generated by the intercompany loans will effectively reduce the taxable base to 0% for as long as the property is owned. Since losses from previous periods can only be carried forward a maximum of 7 years (possibly reduced to 5-years under the proposed new tax rules) depreciation would have little or no effect. Electing for depreciation could also inadvertently serve to increase the taxable gains when the property is finally sold. The decision on whether to use depreciation to reduce the tax base will be made on each property on a case-by-case basis.

### Capital Gains Taxes

The Czech tax code does not recognize, nor treat, Capital Gains specially. Instead any realized capital gains are treated as ordinary income (i.e. buy low-sell high) and taxed at the normal corporate rate of 31% (or personal rate as the case may be). Capital losses are generally deductible for tax purposes.

In the case where real estate assets are held by an individual, there are no tax implications on the gains from the sale to that individual if the property is held for a certain period of time (usually 2-5 years). Unfortunately, such a holding structure by individuals is impossible to achieve for the purposes of this Fund.

However, in the case of real estate transactions where the real estate itself has been held for at least 5-years by a corporation (as is generally planned for in this Fund), there are no tax implications on the profits

resulting from the sale of the shares of the company holding the property.

This strategy, however, requires that the buyer be willing to accept purchasing a Company as opposed to the actual property. There is an advantage to the purchaser for this because they can avoid the tax when they sell by using a similar structure (as well as the expense of setting up a company to hold the property). But, it cannot be assumed that all properties will be disposed without the corporate tax liability on the realized gains in value.

It is planned to use the interest expense from the intercompany loans to run an accumulated deficit in the property company’s earnings such that it offsets taxable gains in the property value.

### Annual Real Estate Taxation

Real estate taxation comprises a tax on land (land tax) and a tax on structures (building tax). The tax on land depends on the quality of particular land, its location and use. The tax on buildings is not based on market value but on physical characteristics, with its price being used only when it is higher than the price computed according to the law. The taxation period is one calendar year.

Land tax is imposed on plots of land entered in the Real Estate Cadastre and is payable by the owner or user. A rate of 0.75% of the official price applies to arable land, hop-fields, vineyards, gardens and orchards, whereas a rate of 0.25% of the official price applies to meadows, pastures, commercial forests, and ponds used for fish farming. Land tax on building land for which a building permission has been granted amounts to CZK 1 per sqm.

Building tax is calculated according to the registered ground area of the building: CZK 1, 5 or 10 per sqm. in the case of business premises, CZK 1 or 3 per sqm. for residential buildings; this amount rises by CZK 0.75 per sqm. for each additional floor.

Furthermore, rates in respect of building land or built-up areas are multiplied by a coefficient which varies according to locality, ranging from 0.3 to 4.5 in Prague. Thus, the annual tax on a 100 m<sup>2</sup> flat in Prague amounts to about CZK 1,000 (EUR 33)

### One-Time Real Estate Transfer Tax

The uniform rate of the real estate transfer tax is 5% of the purchase price. If the purchase price is deemed to be under market value, the authorities will force a market value assessment and tax on the basis of that valuation.

Furthermore, the tax is due from the seller. In the case that the seller does not pay the tax, the authorities will charge the buyer. Thus, it is important to ensure during the transaction that the tax gets paid upon purchase.

The ownership structure set out in this plan makes it possible to eliminate this 5% tax. This is because the tax is only due when the actual title to a property is transferred. Under this Fund's structure, all properties are owned by companies. Instead of selling the properties, the Fund will sell the companies owning the underlying asset; thus, circumventing the tax. The rule is that the company must own the property for longer than 5 years (which is the average holding time expected for this Fund). If the property is owned for less than 5 years by the company, the seller would have to retain a minimum of 1% of the company until the 5 year period is complete. Otherwise, the full transfer tax will be due. Since it is a principal objective of the Fund to hold all properties in the portfolio a minimum of 5 years, this should not be a large issue.

Though routinely discussed as a common practice in commercial deals, it is not the Fund Management's opinion that it is realistic to find buyers of residential real estate who are willing to accept the seller continuing to own 1% of their home just so the seller can get out of 5% tax. This strategy, however, requires that the buyer be willing to accept purchasing a Company as opposed to the actual property. There is an advantage to the purchaser for this because they will avoid the tax when they sell. But, it cannot be assumed that all properties will be disposed without the transfer tax liability.

To understand the impact of the tax, assume the value of all properties in the portfolio doubles from EUR 5.0 to 10.0 million and all the properties are sold for a total of EUR 10.0 million in year 7 (representing approximately a 10% annual increase in value). If every property in the portfolio ended up having to pay

the 5% tax, the total tax bill would come to EUR 500,000. As illustrated below, the impact on IRR would be about 80 basis points.

The Czech Republic's Cabinet recently agreed to reduce the 5% rate to 3% as early as May 2004, although it must be emphasized that this has not yet been passed by parliament and its likelihood of passing into law is still uncertain.

### Withholding tax on dividends and interest

Generally, dividends and interest distributed by a resident company to its foreign shareholders or creditors are subject to withholding tax in the Czech Republic at a rate of 15%. The withholding tax rate may be reduced, if applicable, under a double taxation treaty concluded between the Czech Republic and the country of which the shareholder is a tax resident. It is for this reason that all PROPCO holding companies are owned and financed by companies in the Netherlands where its treaty with the Czech Republic reduces both the Dividend and Interest withholding taxes to 0%.

Half of the Czech withholding tax withheld from the distributed dividend is deductible from the corporate tax liability of the Czech dividend payer in the year in which the dividend is paid. This effectively reduces the dividend withholding tax by one half. However, if this deduction cannot be utilised, e.g. in a loss situation, then this right cannot be carried forward. Any Czech withholding tax withheld from interest payments is treated as an advance payment and credited against the total tax liability for the tax period.

### Value Added Tax

VAT is commonly referred to using the Czech Acronym "DPH". Most services are subject to a 5% VAT rate, with most sales of goods being subject to a 22% VAT rate. The VAT rate on the sale and lease of buildings, if applicable, is generally 5%.

A law is pending that would increase the VAT rate on most services to the 22% rate as early as January 1st, 2004. In fact the Czech parliament had passed the measures this year, but the Czech President Vaclav Klaus unexpectedly vetoed the increases in July 2003. The changes are considered necessary to bring the Czech Republic's VAT laws in line with the EU standards.

Under the proposed changes, rent would be subject to the 22% rate, but the sale of buildings if applicable at all would still be subject to the 5%. Under most circumstances, the PROPCO subsidiaries of the Fund will not elect to be VAT payers in order to remain more competitive in the rental market.

The transfer of land is VAT exempt. The transfer of buildings two years following their acquisition or approval of use, are also exempt from VAT. The lease of land and buildings is generally VAT exempt but there is an option for applying VAT in specific situations.

If a company registered for VAT purchases a building for its entrepreneurial activities, it is in principle entitled to claim input VAT. A full refund will be granted if the building is only used for activities that generate non-exempt taxable supplies. However, no refund will be granted if the building is only used for exempt supplies. A partial refund will be given if the building is used partly for non-exempt and partly for exempt supplies. Hence, one could theoretically register as a VAT payer; lease the property out to VAT paying tenants for a few periods, then move in and live there as a non-VAT payer. This practice is considered shady at best and will not be employed by any of the Fund's PROPCOs.

As of 1 January 2001, a change in the use of a building (e.g. from non-exempt to exempt activities) in the ten years subsequent to its acquisition may have an impact on the input VAT claimed. In certain situations this may imply that (part of) the claimed input VAT has to be paid back.

Almost all developers selling newly constructed units include VAT in their selling prices. The fact is that they do this in order to reclaim the VAT from their input supplies, which can be substantial. Thus, buying from individuals can lead to quite a savings since no individuals charge VAT.

#### Reserve fund

The company is bound to create a "Reserve Fund" from the net profits in the year when profits are first attained according to the annual financial statement. The Reserve Fund is to be created in an amount equal to at least 10% of net profits, but without exceeding 5% of the value of the registered capital (thus, CZK

10,000 on a typical company capitalized at CZK 200,000). This fund shall be annually replenished by an amount determined in the memorandum of association or articles of association of at least 5% of the net profits, until the fund reaches the level stipulated in the memorandum of association or articles of association, such level being equal to at least 10% of the registered capital (thus, amounting to CZK 20,000 on a typical company capitalized at CZK 200,000).

## The Future of Taxes in the Czech Republic

As of 12-May, 2003 the Czech Republic's governing Cabinet of Public Finance announced sweeping tax measures designed to increase the flow of funds into the Country over the next 3 years.

The measures would include a series of cuts in the corporate tax rate over the next few years: from the current 31% to 28% in 2004, to 26% in 2005 and finally to 24% in 2006. In accordance with the European Union's tax plan, taxes on services will be moved into the 22% bracket from the current 5% (the Czech Republic is the only nation in Europe to have a multi-tier VAT scheme).

Furthermore, the tax on real estate transactions, currently 5%, will fall to 3%.

Currently the Czech Republic's corporate tax @ 31% is amongst the highest of its neighbours joining the EU in 2004. Slovakia for example has recently passed a law reducing its corporate tax to 19%. Hungary's rate is a low 18% and Poland's rate is scheduled to drop to 22% in 2004. It must be emphasised, however, that changing tax rates does not necessarily mean changes in the true tax burden. The tax rate must be applied to the tax base, indirect taxes, and other financial inducements in order to measure the real tax burdens. For investors a key aspect of tax planning is the recognition of costs and expenses. This is the essence of the Fund Management's objectives.

The consequences for the Czech Republic include immense pressure to follow through with its plans to reduce its tax burdens in order to remain competitive as an investment centre. There are also many other measures planned in the Czech Republic that are beyond the scope of interest of the Fund.