JOINT VENTURES IN CZECHOSLOVAKIA

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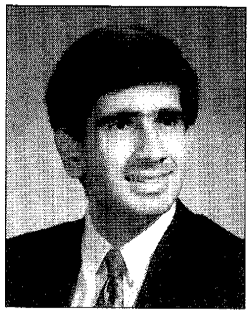

After the "Velvet Revolution" in 1989, Czechoslovakia moved from a centrally planned economy towards a free market economy. With the introduction of a free market economy, Czechoslovakia now faces many new obstacles and problems, much like those experienced by its neighbors, Hungary and Poland. At least in the short run, it will have to deal with increased inflation, unemployment, and a decrease in gross national product. In addition, trade with its largest trading partner, the former Soviet Union, has decreased drastically. However, the people and government of Czechoslovakia can look elsewhere for increased capital inflows and economic assistance. One of the options available is the joint venture, a solution which may enable Czechoslovakia to increase its industrial and economic strength.

This paper explores the availability and feasibility of joint ventures within Czechoslovakia. A joint venture is formed by a group of firms or individuals who contribute resources towards forming such an entity. Typically, joint ventures have been used to introduce new businesses, acquire new technologies, and enter new markets. They enable two or more parties to benefit from their respective strengths. These parties then share in the benefits and losses incurred. In analyzing joint ventures, it is important to realize the advantages and disadvantages of choosing this particular form of business organization, along with the legal, tax, and accounting consequences that will eventually affect both parties.

Advantages and Disadvantages of Forming Joint Ventures

A joint venture can be undertaken for a number of reasons. In the case of Eastern Europe, a foreign corporation may wish to establish an operation to benefit from government grants, subsidies, or tax incentives which only may be granted to a local business. Tax incentives may be of particular importance in the formation of a joint venture, especially if double-taxation is an important consideration. These incentives will permit a corporation to form a joint venture in a country where indigenous businesses are taxed at a much lower rate.

Moreover, the formation of a new entity will result in the joint venture having greater synergy and power. This advantage can enable it to compete against larger and more dominant organizations within the country itself as well as in a global context.

However, there are some disadvantages to forming a joint venture. A partner in a joint venture will be surrendering a portion of its independence in a number of areas. For example, a partner will no longer be able to make a decision by itself unless it has been given the power to do so by the other partner. Some decisions might be reached only after extended discussion. This can waste valuable time and may possibly result in animosity between the partners. If a falling out among the parties does in fact occur, then the disposal of jointly owned assets and the protection of trade secrets may become problematical.

Czechoslovakia appears to provide fertile ground for the formation of joint ventures. Before World War II, Czechoslovakia had one of the strongest economies in Europe. Its gross domestic product was the seventh largest in the world.(Agency for Foreign Investment,p.6) However, during the forty years of the communist regime Czechoslovakia's economy stagnated. A scarcity of investment and inadequate management skills combined to produce a noncompetitive industrial sector. Although some economic reforms were implemented in the 1980s, they did not have a major impact on Czechoslovakia's industrial strength and capability.

Following the overthrow of the communist regime, major changes in banking, foreign exchange, and company laws were enacted. In addition came legislation pertaining to foreign trade, price liberalization, and certain types of privatization. This has paved the way for foreign investment in the Czechoslovakian industrial sector. This foreign investment will provide a boost to the newly emerging private sector by contributing much needed capital, technological expertise, and modern management techniques. As a result, the possibility for joint ventures in Czechoslovakia has been greatly enhanced.

Currently, the Foreign Trade Ministry is optimistic about the outlook for joint ventures and foreign investment in Czechoslovakia. According to Josef Baksay, the Minister of Foreign Trade, a major task of the Foreign Trade Ministry "is to survey the trade world and prepare the ground for companies."(*Journal of the Czechoslovak Chamber of Commerce and Industry*, p. 4)

To make the economic environment more attractive to investment, the government is implementing economic policies designed to curtail inflation. For example, the money supply and wages are being tightly monitored and controlled. In addition, credits and subsidies to businesses are being limited. The government is also hoping to maintain low interest rates and to stabilize the exchange rate.

Currently, foreign investors are free to participate in joint ventures with Czechoslovak partners. There is no existing restriction on the amount of investment allowed, and an enterprise may have 100 percent foreign ownership.(Agency for Foreign Investment,p.1) A joint venture may be formed between persons or companies and may be structured in a number of different ways: a joint stock company (public limited company), an association, a private limited company, a limited partnership, a partnership limited by shares, a general commercial partnership, or a trade association. (Antrobus,p.2) Interested parties seeking to form a joint venture can contact the Agency for Foreign Investment which will provide further guidance. At the present time, the great majority of joint ventures have been structured as joint stock companies since explicit legislation dealing with joint stock companies has been passed. However, legislation regarding other types of joint ventures is expected shortly.

Specific authorization from the government is required only for joint ventures which involve the participation of state enterprises. Other joint ventures need only be registered with the government. This registration procedure can, however, sometimes take up to three months. Joint ventures can be formed in all areas of Czechoslovakia's economy except sectors that deal with defense matters or national security.

If a joint venture is established, it must follow specific procedures. Its accounting books and records must be expressed in Czechoslovak crowns (korunas). As of October 1991, the exchange rate was approximately 30 crowns per United States dollar. Furthermore, the joint venture must prepare an annual statement which must be audited by two auditors, at least one of whom must be legally registered in Czechoslovakia.

A foreign investor may also establish a wholly-owned subsidiary in Czechoslovakia. This subsidiary may be formed as either a joint stock company or a private limited liability company. However, certain rules and regulations must be followed. Both joint stock companies and private limited liability companies must have a minimum share capital of 100,000 crowns. The joint stock company must price individual shares as a multiple of 1,000 crowns. In addition, it must have a company charter. Unless the subsidiary is being set up in a restricted industrial sector which a private entity is not permitted to enter, it does not require specific authorization. It must only be registered with the Federal Ministry of Finance.

If the foreign investor opts to form a joint stock company, the joint stock company must contain a board of directors of between three and eleven members, none of whom must be Czechoslovak citizens. (Antrobus,p.2) A supervisory board of at least three members is required. The joint stock company must also establish a reserve or restricted fund equivalent to a minimum of ten percent of its share capital. In addition, it must pay five percent of net profits to the reserve fund until the specified amount is reached.

As of October 1991, 2,900 joint ventures have been registered with the Federal Ministry of Finance. Of these, 2,224 are registered in the Czech Republic, and 676 are registered in the Slovak Republic. Foreign investment has amounted to 10,262 million crowns or about forty-three percent of the total investment of 23,878 million crowns.(Agency for Foreign Investment, p. 19)

The initial investment in the joint venture has typically been small, about 500,000 crowns or less. However, 340 joint ventures have been started with investments of one million crowns or more. The majority of joint ventures so far have come from Germany (861), followed by Austria (821), Switzerland (197), Italy (134), and the United States (132).(Agency for Foreign Investment,p.19) As of April 1991, the largest investment has been made by Volkswagen of Germany, an investment of 198,900 million crowns in a joint venture with Skoda and Baz. The largest investment in a joint venture by an American Company, 2,400 million crowns, has been made by U.S. West, a telecommunications company, with the Federal Government of Czechoslovakia. Other joint ventures entered into by large American corporations have included IBM, General Electric, and Procter and Gamble Co.

Forming Joint Ventures in Czechoslovakia

After considering the various advantages and disadvantages along with specific rules and regulations, a foreign enterprise must follow four steps if it wishes to form a joint venture with a private company:

1) it must provide a minimum capital requirement of 100,000 crowns, with the option of payment in hard currency;
2) it must deposit at least 50,000 crowns or thirty percent of the initial capital investment in an account with an authorized Czechoslovak bank;
3) registration must take place with the Ministry of Finance;
4) the company agreement must be filed in a local court.

As mentioned before, joint ventures are being formed with companies that have been recently privatized in Czechoslovakia. Beginning in 1991, the privatization of state enterprises was initiated, and it is expected that over 100,000 small to mid-size businesses, including shops, service companies, and restaurants, will be sold at auctions. Foreigners will not be able to join in the first round of the auctions. Moreover, newly privatized enterprises are not allowed to be sold for two years, so this precludes foreigners from acquiring these businesses. As of October 1991, 5,000 such units have been privatized.

According to the regulations for privatizing small state enterprises, if businesses are not sold for at least fifty percent of their stated value in the first round, they will be offered for sale again in a second round. Foreign investors are allowed to participate and purchase units in this second round that began on June 16, 1991. The businesses must be sold for at least twenty percent of their value in the second round. The Ministry for the Administration of National Property has so far approved another 9,000 units for the second round of auctions.

The other type of privatization deals with large scale enterprises and will utilize a voucher system. Four different types of parties will be able to purchase large enterprises: state property funds, Czechoslovak citizens, foreign investors, and private investors. The Czechoslovak government hopes that foreign investors will play a major role in large scale privatization. Currently, the Ministry of Privatization must approve the formation of any large scale joint venture.

Examples of Joint Ventures

On June 19, 1991, Procter and Gamble Company, the largest consumer products company in the United States, purchased one hundred percent of Rakona, a Czechoslovakian detergent producer. Procter and Gamble was the first American corporation to make a large direct investment in Czechoslovakia. The deal was significant for two reasons: it was the first 100 percent purchase of a Czechoslovak company by any foreign company; and it was the first acquisition under the Large Privatization Act.

Under the terms of the agreement, Procter and Gamble paid a total of 1,320 million crowns. It will pay 600 million crowns to Czechoslovakia's national property fund in exchange for Rakona's assets, whereas the other 720 million crowns will be invested in Rakona over a span of two years. Moreover, approximately 725 employees will be given five common shares along with a guarantee that no employees will be fired for a two year period. After this period, Procter and Gamble has pledged not to reduce its workforce by more than thirty percent. Procter and Gamble also proposes to make Rakona its only manufacturing site for detergent products in Eastern Europe. With this agreement the company hopes to access distribution channels within Czechoslovakia as well as Poland, Hungary, Romania, Bulgaria, and Yugoslavia. According to Procter and Gamble's manager for Czechoslovakia, Mr. Harter, "The intent of the Czech and Slovak government regarding foreign investment is extremely positive."(Agency for Foreign Investment, p. 21) Procter and Gamble also hopes to engage in other joint ventures in the future.

Another example of a joint venture is LUNA ROSSA ,a joint Czechoslovakian-Italian Company, which was founded on January 1, 1991. LUNA ROSSA manufactures clothes with state-of-the-art technology from the RIMOLDI firm. Production using a ready-to-go system was initiated on April 1, 1991. The enterprise has a production capacity of 2,000 shirts per shift, and will be fed material from the Perla state enterprise at Usti nad Orlici. The Czech and Italian sides each share a 50 percent stake in this joint venture.(*Journal of the Czechoslovak Chamber of Commerce and Industry*, p. 10)

Volkswagen is another foreign firm which has invested a large amount of capital in Czechoslovakia. Over the next ten years, it plans to spend approximately 183 billion crowns in order to rebuild the Czechoslovak carmaker Skoda. This represents about 10 percent of Czechoslovakia's gross national product. Volkswagen plans to sell 500,000 Czechoslovakian Skodas and Volkswagens in Europe over the next few years.(Templeman, et al., pp. 51-52) It hopes that Skoda will become one of its lowest cost production centers in Europe. "Completing the Skoda deal is really going to open the doors in Czechoslovakia," says Brussels-based lawyer, Daniel Arbess.(Schares, p. 55)

Restitution and Convertibility of Profits

An important consideration for many potential investors is the possibility of property being returned to its former owners. Property that was confiscated between February 25, 1948 and January 1, 1991 is now being given back to former owners under the Law on Extrajudicial Rehabilitation which was passed on February 21, 1991. However, enterprises that contain foreign capital, commercial properties owned by natural persons, and foreign states are exempt from restitution for ten years. But, if the property was acquired after October 1, 1990, this exception from restitution does not apply. Moreover, land may not be given up if a building has been erected on it since the implementation of nationalization. It should be noted that only ten percent of the property in Czechoslovakia is subject to restitution. For example, agriculture, large industries, properties nationalized before 1948, and churches are excluded from restitution. Obviously, before entering into any purchase agreement, parties to a possible joint venture should check all claims made against the property.

Another major consideration for many foreign investors pertains to the convertibility and repatriation of profits. The Foreign Exchange Act of November 28, 1990, stated that both domestic and joint venture companies must exchange any foreign currency earnings into Czechoslovak crowns. A company may avoid the exchange requirement if it can convince the state bank that it contributes significantly to the foreign exchange balance. However, the state bank has so far approved only exceptional cases.

If a domestic company has monetary obligations abroad, it may request to buy foreign currency from banks. This request is granted in most cases unless the foreign currency is used to buy either immovable assets abroad or foreign securities. The company buys foreign currency at an exchange rate which is tied to a number of foreign currencies: the Austrian schilling, the French franc, the German mark, and the United States dollar.

Currently, the repatriation of a firm's profits is possible under a system of internal convertibility. Therefore, a joint venture company may transfer its returns on investment abroad. Returns which may be repatriated include profits from entrepreneurial activity, interest payments, capital growth, returns on bonds, and payments for intellectual property. Financial accounts or appropriate documentation are necessary to prove that the funds in question actually represent a return on investment. At present, many countries have approved bilateral agreements with the government of Czechoslovakia enabling profits and capital to flow freely.

Any potential investor must also analyze the tax consequences of investing in a foreign country. Czechoslovakian legal entities must pay taxes on their income earned all over the world. The entity's profits are taxed at a flat rate of 40 percent if foreign ownership in a joint venture or subsidiary is greater than 30 percent. However, if foreign ownership is less than 30 percent, the entity must pay a flat tax of 55 percent. If taxable profits do not exceed 200,000 crowns, the entity is subject to a tax rate of only 20 percent. The tax rate of 40 percent is also used for representative offices and other permanent establishments of foreign companies. However, an enterprise may seek exemption under the provision of a double taxation treaty. A joint venture or subsidiary is not subject to state or municipal taxes.

In determining the appropriate amount of tax, Czechoslovakia uses accounting standards and rules that are different from Western international accounting standards. Currently, the government only partially recognizes accrual accounting. For example, the establishment of provisions for stock obsolescence and warranty reserves is not permitted. For the difference between capital and revenue transactions, no adjustment is made for tax purposes. Also, losses during the taxable year may not be carried forward or back. However, a limited carry forward provision can be expected soon.

The payments of dividends from Czechoslovak and foreign income are included in pretax profits. An enterprise may seek relief by receiving a tax credit for foreign taxes incurred up to the amount of its Czechoslovak tax liability. However, dividends and payments between Czechoslovak entities do not receive tax credits.

Tax incentives exist for newly established Czechoslovak businesses. A business can apply to the State Ministry of Finance for a tax holiday or a reduction in the business profits tax. If a joint venture exists in certain favored industrial sectors, it may apply for a tax holiday that is greater than two years, which represents the normal time extended to newly formed enterprises.

These tax laws are just the beginning of a long series of expected tax reforms. It is anticipated that the major tax reform legislation will be introduced in 1993.

Conclusion

Investment opportunities appear to be good in Czechoslovakia. The government seems eager to help new investors who wish to participate in the transition to a free market economy. However, investors must still act with caution. Inflation, the volatility of the exchange rate, and the political climate are just a few of the factors that must be examined. Many large companies have already invested considerable sums. Although most have not seen immediate profits, many companies hope to establish a base and build upon it. If foreign investors can capitalize on the available opportunities in Czechoslovakia, they may earn substantial returns on their investments.

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