Tax and Legal News

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EY
Building a better working world

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Pillar 2 is coming

Presently, there is no bigger change in the tax world than Pillar 2. Some of those affected have not yet started to address it, some have delegated responsibility to their headquarters (after all, implementation requires a central procedure) and others are already immersed in the details. It's a big change for one obvious reason: the introduction of taxation based on purely accounting variables. So, it requires working with source data that until now has tended to show the tax rather than determine it. On that note, working with deferred tax warrants special consideration.

But beyond that are a number of other considerations that are not entirely of implementation nature. For example, I think that Pillar 2 has the potential to change the tax competitive environment among countries and even among individual businesses. Among countries, so that the effective tax rate is set at the jurisdiction level, essentially giving large high-tax jurisdictions the ability to offer tax breaks along the lines of investment incentives without the (effective) tax rate per jurisdiction falling below 15%. Same incentives, same size project, just a different, smaller, jurisdiction, and it means a 15% surtax because the other group's business in the jurisdiction will not provide the appropriate cushion. In the second case, the effect of the incentives is reduced to being completely wiped out.

The competitive environment among businesses is influenced by the fact that there may be two competitors in a given jurisdiction, both with an effective tax rate of 10%. But one of them, let's say the smaller one, will pay 5% on top of the effective tax rate of 10% just because it is part of a large group. It can be expected to make a surcharge in its jurisdiction, because the rational behaviour of all EU countries is to introduce a qualified domestic top-up tax, since the tax will otherwise be levied by another jurisdiction. It thus seems to me that Pillar 2 has discriminatory potential. Unlike the increased reporting for large groups, this is already a higher tax burden.

There is no Czech implementation of the directive; individual Member States are moving forward, and it is primarily an OECD initiative, so jurisdictions outside the EU are introducing similar rules. The first safe harbour rules are emerging, the interaction with the relevant double tax treaties needs to be resolved and it will be a while before we have a full picture of the rules, let alone established practice or conflict resolution. The period of uncertainty will continue for some time.

And on top of all this is the public discussion about the need to increase the tax burden in our country, because the state budget deficit is reaching monstrous proportions.

I wish you a pleasant and enriching reading of this edition of our Tax News.

Pillar 2 has the potential to change the tax competitive environment among countries and businesses.

Pillar 2

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Pillar 2 – Do you have the data you need?

In my last two articles, I've gone through my thoughts on why we need to start looking at the potential impact of Pillar 2 now. Simply put - the rules are complex, they are given in principle, implementation will be extremely fast, the potential impact may be material.

Let's take a look at what data and information multinational enterprise groups will need to calculate the impact of Pillar 2 in each relevant jurisdiction and prepare appropriate submissions to the tax authorities. Let's ignore for a moment the safe harbour rules (which we have informed you about in our February 2023 Tax and Legal News), which may temporarily simplify the practical application of Pillar 2.

Not entirely surprisingly, accounting data will need to be identified and assessed - in most cases accounting data under International Accounting Standards. In particular, income, expenses, tax payable and deferred tax, revaluations recognised in equity, intercompany transactions. In the detail that is common for tax returns, i.e. in great detail, in principle itemised. IFRS reporting packages sent on 3 January of the following year will certainly not be sufficient to determine the adjusted profit for the calculation of the effective tax rate. Detail will be needed for each company separately. This can be a hard nut to crack, which will require adjustments to IT systems, processes and methodologies.

Another not entirely surprising group of data will be tax data - income tax paid on the basis of the regular return and any differences on the basis of corrective returns, detail on the controlled foreign companies regime applied, companies where tax transparency is applied (and what the result is), tax regime for intra-group transactions, detail on permanent establishments, etc. The amount and detail of data can surprise even an experienced group tax manager.

To make matters worse and to involve multiple departments in each company, it will be necessary, for example, to find out the number of employees, the costs incurred (including social security costs), to check the level of ownership and control in joint ventures and in companies where the group is not 100%, the legal status of immovable property.

Due to the specific regime of the start-up rules, some items that multinational group companies will report in their 2023 financial statements may affect the calculation of the effective tax rate under the Pillar 2 rules in subsequent years. Specifically, deferred taxes can hide pleasant and unpleasant surprises.

Some insight into the vast amount of data that will need to be identified, processed and reported is provided by the OECD's draft paper on standardised GloBE information returns.

There is no one-size-fits-all way to start identifying the potential impact in future years - somewhere you just need to go through the data from the CbCR report, somewhere you just need to look at "special material items", somewhere you just need to focus on the largest jurisdictions, somewhere you need to focus on "usual suspect countries" (countries with low nominal tax rates), somewhere you need to pick a sample of companies. It depends on a lot of parameters, from the size, type and diversity of the group's business, to the countries concerned, to the IFRS accounting treatment.

We intend to pay more attention to this area in our tax reports and alerts.

If you are interested in this area, please contact the author of the article or your usual EY team.

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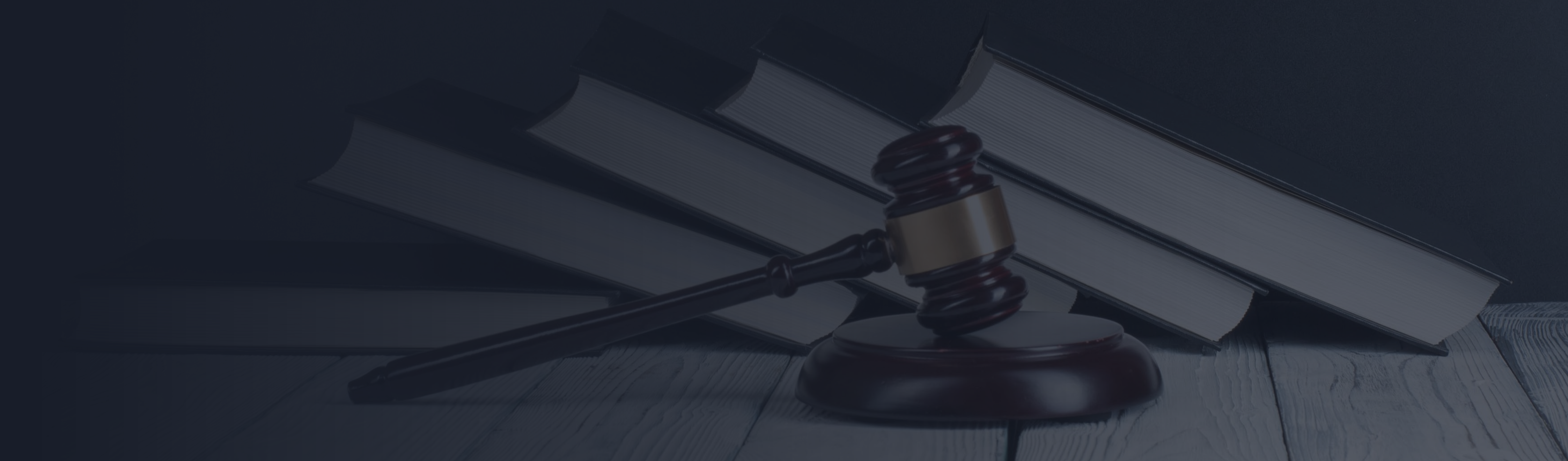
Law



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Regulation on foreign subsidies distorting the internal market

On 12 January 2023, the new EU Regulation on foreign subsidies distorting the internal market (the "Regulation") aimed at protecting the internal market from the distortive effects of certain subsidies ("foreign subsidies") entered into force. The Regulation lays down rules for the tendering procedure and for the approval of transactions, in both cases where a person who has received significant subsidies from a third country is involved. In the case of transactions, this is another parallel regime of their public authorisation, in addition to the classical authorisation of mergers of competitors by the competition authorities and in addition to the still relatively new regime of approval of foreign investments from non-EU countries, the domestic regime of which is regulated by Act No. 34/2021 Coll. on the examination of foreign investments.

A foreign subsidy can take the form of a grant, a loan, debt forgiveness or the supply of goods or services. It may be provided by central government agencies and public authorities at all levels, as well as by foreign public or private entities with activities attributable to a third country. The rationale for adopting rules on foreign subsidies is that in the past some foreign subsidies have facilitated the acquisition of businesses in the European Union, influenced investment decisions, distorted trade in services or otherwise influenced the behaviour of their recipients in the internal market, to the detriment of fair competition. European legislators have therefore concluded that it is necessary to extend the Commission's powers to deal with cases where certain foreign subsidies are liable to adversely affect competition in the internal market.

Whether a foreign subsidy leads to distortions of the internal market is assessed on the basis of indicators such as the amount of the subsidy and its nature, the situation of the undertaking and the markets concerned, the level of economic activity of the undertaking concerned on the internal market or the purpose and conditions attached to the subsidy and its use on the foreign market. In particular, foreign subsidies are considered potentially problematic if they are granted to a company in difficulty which, in the absence of the subsidy, would be likely to go out of business in the short or medium term. Such subsidies may, for example, take the form of an unlimited guarantee for the debts or obligations of an undertaking, thereby directly facilitating a merger or enabling an undertaking to submit an unreasonably advantageous bid on the basis of which it would be awarded a public contract. A foreign subsidy, the total amount of which is less than EUR 5 million over any period of three consecutive accounting years, is considered as not likely to distort the internal market (unless proven otherwise).

The Regulation gives the Commission three new tools in the field of foreign subsidies. The first is the **obligation to notify the Commission in advance of the tendering procedure** if (i) the amount of the contract is at least EUR 250 million and (ii) the tenderer has received foreign subsidies of at least EUR 4 million in the last three years. The second tool is **the obligation to notify the Commission in advance of a concentration**, where (i) the target undertaking or at least one of the undertakings concerned is established in the European Union and has a total turnover in the internal market of at least EUR 500 million and (ii) the undertakings concerned have received a foreign subsidy in excess of EUR 50 million in the last three calendar years preceding the conclusion of the agreement. The notification obligations result in the fact that a public contract cannot be awarded to a tenderer under investigation or the merger cannot be completed until the Commission's investigation and clearance have been completed or the Commission's statement period has expired. At the same time, there is likely to be an increase in the complexity and cost of M&A transactions, as it will be necessary to examine all subsidies granted to the companies concerned in the last three calendar years prior to the completion of the transaction.

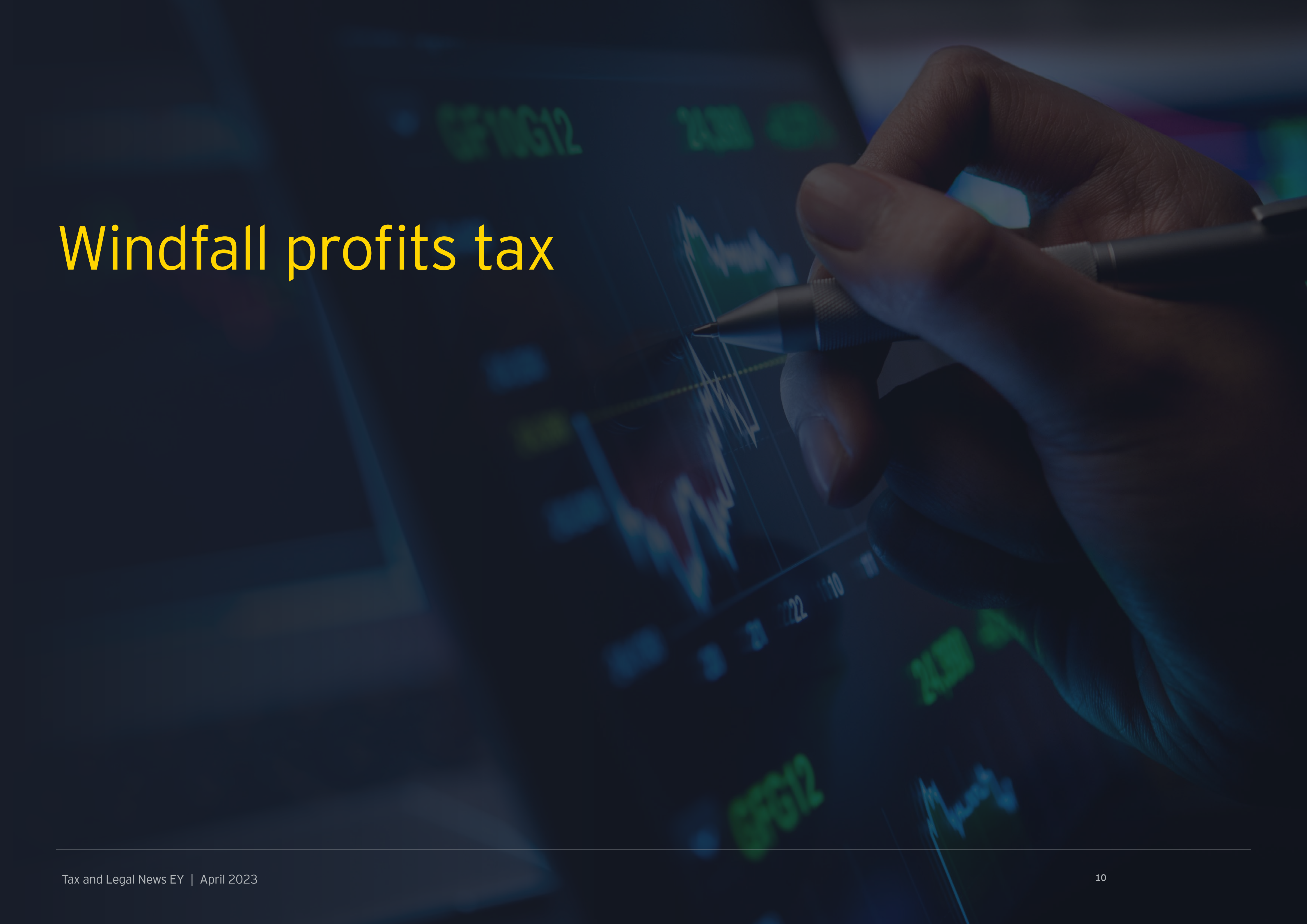
The Commission's third new tool is **the power to examine information on its own initiative** from any source regarding alleged distorting foreign subsidies. At the same time, however, it may compare the negative effects of the foreign subsidy granted in terms of distortion of the internal market with its positive effects on the development of the economic activity concerned. On the basis of this **balancing exercise**, the Commission will then decide whether to impose remedies or accept commitments from the undertaking concerned.

The Regulation also allows the Commission, subject to conditions, inter alia, to carry out inspections of undertakings inside and outside the European Union, to impose fines and penalties of up to 10% of annual turnover, to adopt interim measures, to impose corrective measures or to accept commitments proposed by the undertakings concerned. Remedies or commitments may include, for example, reducing capacity or limiting market participation, refraining from certain investments, divesting certain assets, requiring the undertakings concerned to dissolve a merger, or repaying a foreign subsidy, including an appropriate interest rate.

The Regulation applies to foreign subsidies granted in the five years prior to 12 July 2023 if, after that date, the foreign subsidies in question distort the internal market. Most of the provisions of the Regulation will also take effect from 12 July 2023; the notification obligation for undertakings in the area of public procurement procedures and mergers will apply from 12 October 2023.

If you have any questions, please contact the authors or other members of EY Law or your usual EY team.

A new EU regulation has implications for transactions and procurement in relation to subsidies from third countries.



Windfall profits tax

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Information on the application of windfall profits tax

The Financial Administration recently published interesting information on the application of windfall profits tax on its website:

- Questions and answers on the application of windfall profits tax – more (in Czech) HERE.

- Replies of the Czech Statistical Office (CSO) to the General Financial Directorate's (GFD) questions on the classification of specific activities according to CZ-NACE for the purposes of windfall profits tax – more (in Czech) HERE.

In addition, the GFD sent to the Chamber of Tax Advisors additional answers to selected questions on windfall profits tax (the "Document"), while most of the answers in the Document were not published in the aforementioned Questions and Answers.

Below, we briefly highlight a few selected aspects that stood out to us in the context of the above.

- *Spin-off and abuse (contained in the Document)* – If a windfall profits taxpayer decides to spin off other activities (i.e. those that do not generate relevant income) into an existing or newly established company that will not be subject to windfall profits tax because it does not carry out relevant activities – the GFD has indicated that such a procedure could be viewed as abusive if it could be shown that the only reason for the spin-off is to reduce tax liability because, according to the text of the law, all income is taxable in the specified tax period.

- *A taxpayer created after 2021 other than by conversion (contained in the Document)* – In the case of a taxpayer formed after 2021 (being part of a group with windfall profits and not formed by conversion), the GFD has stated that the windfall profits tax will not apply in such a case as the conditions for the formation of the tax base in accordance with § 20ba(2) of the Income Tax Act (ITA) are not met, as there is no comparative tax base.

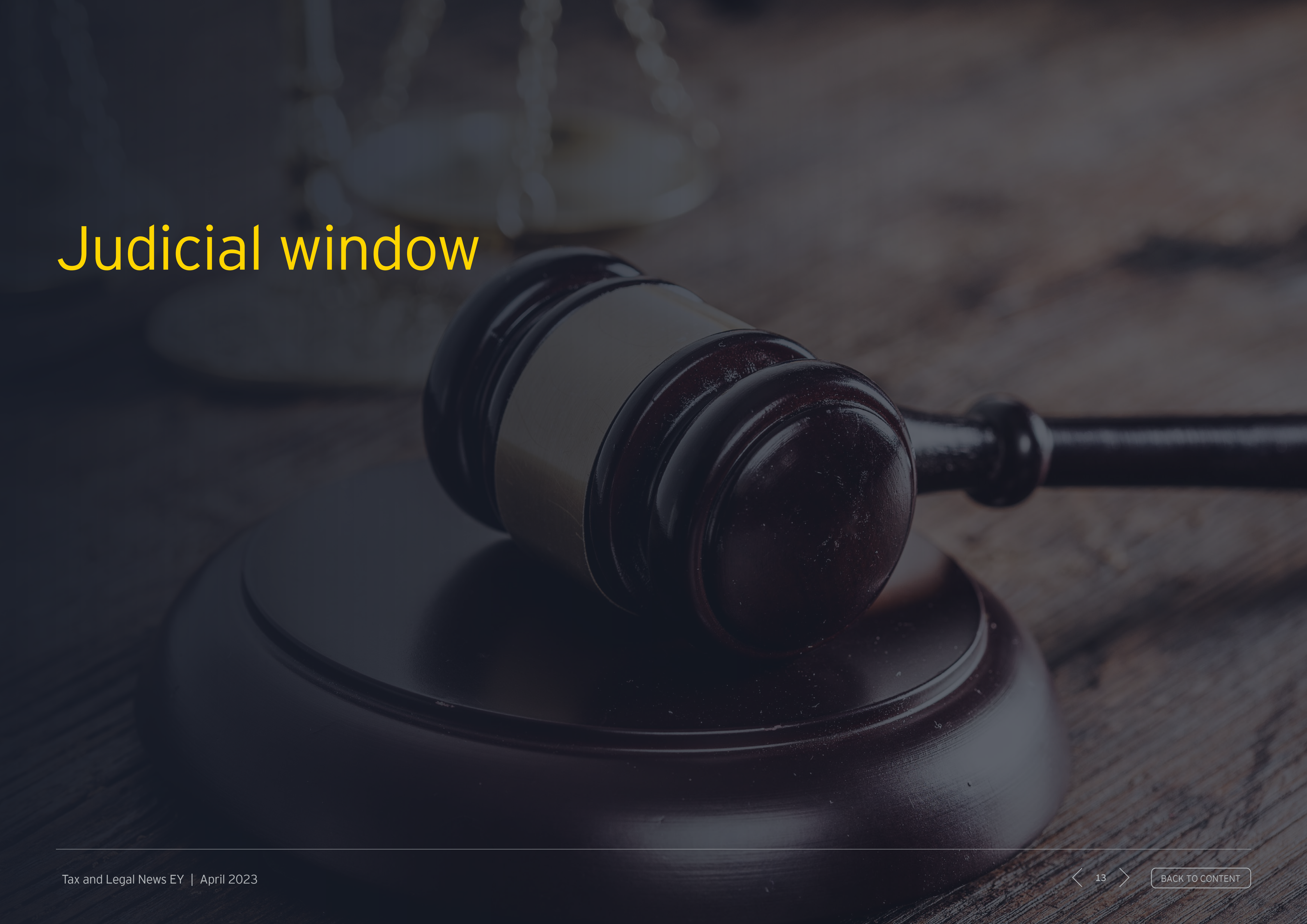
- *A taxpayer created in 2021 other than by conversion (contained in the Document)* – According to the GFD, the windfall profits tax is applied even if there is only one comparative tax base.

- *Assessment of the relationship of the revenue to the relevant activities* – Proceeds from the sale of property used in or acquired for or in connection with the carrying on of a qualifying activity should be relevant income, as should, for example, revenues related to sales or other income arising in connection with qualifying activities (exchange differences, contractual penalties, default interest).

- *Energy billing to a tenant (contained in the Document)* – If the lessor is not a supplier of electricity or gas, i.e. only provides a service consisting in the arrangement of electricity or gas supply for the lessee, such income does not meet the definition of income from a qualifying activity according to § 17c(6) of the Income Tax Act.

If you are interested in this area, please contact the author of the article or your usual EY team.

If a windfall profits taxpayer decides to spin off other activities (i.e. those that do not generate relevant income) into an existing or newly established company that will not be subject to windfall profits tax because it does not carry out relevant activities – the GFD has indicated that such a procedure could be viewed as abusive if it could be shown that the only reason for the spin-off is to reduce tax liability because, according to the text of the law, all income is taxable in the specified tax period.



Judicial window

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The Supreme Administrative Court on the determination of the tax base on income derived by non-residents from public performances of artists

We bring you a judgment of the Supreme Administrative Court (SAC) on the issue of determining the tax base on income from public performances of tax non-resident artists in the Czech Republic (the years 2013 to 2015 were dealt with).

Background

- A company organized public performances of foreign artists and paid a fee to foreign agencies that represented these artists.
- The tax administrator considered the total payment made by the company to intermediary agencies as income from the activities of a public performer in the Czech Republic subject to withholding tax.
- However, according to the company, the part of the remuneration to the agencies that was not the artist's remuneration for the public performance but the remuneration to the intermediary reflecting, inter alia, its costs of arranging the performance cannot be considered income from public performance within the meaning of § 22(1)(f)(2) of the ITA or international double tax treaties.

View of the Municipal Court

- According to the Municipal Court, in a situation where income does not accrue directly to the performer but to another person, the State in which the performance took place is entitled to tax the income only if the person to whom the income accrues has a permanent establishment in that State.
- According to the Municipal Court, Article 17(2) of the OECD Model Treaty was introduced in order to avoid circumventing the rule on the taxation of performers' income under Article 17(1).
- Therefore, according to the Court, the tax administrator erred in imposing tax liability in relation to the income of foreign agencies for arranging appearances.

- In the circumstances, only the income of the public performer should have formed the tax base.
- Income accruing to another person, even if representing the artist, is not subject to the regime of Article 17 of the OECD Model Treaty, therefore the Czech Republic's right to tax it would be given only in the case of the existence of an establishment of such a person in the Czech Republic.
- The Municipal Court did not identify the applicable international double tax treaties – it limited itself to interpreting the OECD Model Treaty in light of the OECD Commentary.

View of the SAC

- The Supreme Administrative Court (SAC) annulled the judgment of the Municipal Court mainly due to the fact that the Court did not identify the applicable international double tax treaties and limited itself to the interpretation of the OECD Model Treaty in the light of the OECD Commentary.
- According to the SAC, the Municipal Court must, in further proceedings, identify the double tax treaties actually applicable in the present cases, in conjunction with the determination of the tax residence of the persons who received income from the artists' public performances.
- Nevertheless, the SAC still expressed its opinion on the disputed legal issue.
- In order to be taxed under Article 17 of the OECD Model Treaty, regardless of whether the income is to be taxed under paragraph (1) or (2), according to the SAC, it must always be income provided in consideration for an artistic performance and not for other activities, such as arranging the performance.
- Therefore, assuming that the Municipal Court finds the OECD Model Treaty, or the OECD Commentary, to be interpretatively relevant in further proceedings in view of the applicable international double tax treaties, it will be necessary to address, first and foremost, the nature of the income paid by companies to intermediary agencies. For this purpose, the Municipal Court should assess, taking into account the contracts concluded by the company with these agencies or the accounting documents (invoices), what part of the payment provided can be considered as remuneration for the artist's personal public activity and what part is instead provided as remuneration to the intermediary agency, for example as a commission for arranging the artistic performance or remuneration for other consideration (participation in the production of the performance, etc.).
- According to the SAC, this second part of the remuneration (commission, remuneration to the agency for arranging the production) typically cannot be regarded as income from the personal artistic activity of the artist and therefore cannot be subject to taxation under the double tax treaty regime corresponding to Article 17 of the OECD Model Treaty.

If you are interested in this area, please contact the author of the article or your usual EY team.

According to the SAC, the part of the remuneration due to the agency for arranging the production cannot typically be regarded as income from the personal artistic activity of the artist and therefore cannot be subject to taxation under the international double tax treaty regime corresponding to Article 17 of the OECD Model Treaty.

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Municipal Court in Prague on the deductibility of intra-group services on the basis of a monthly lump sum

We bring you another interesting judgment concerning the proof and deductibility of intra-group services (2012).

Background

- Foreign companies provided Czech companies in the group with services related to, among other things, accounting and administration, where the remuneration was agreed in the form of a monthly lump sum according to the calculated expected costs.
- The tax administrator asked the recipient to provide evidence and found that an overhead surcharge of 75% of the related wage costs had been applied, i.e. not the actual overhead costs.

View of the tax administrator and the Court

- According to the tax administrator, the lump sum compensation cannot be determined on the basis of an estimate alone without the necessary documents – the calculation for determining the lump sum must, according to the tax administrator, be broken down and supported by documents at any time.
- According to the tax administrator, the company did not prove the complete scope of the invoiced activities, but only the part of the invoiced activities that was substantiated by the actual activities carried out, i.e. the part of the total amounts claimed in taxable expenses corresponding to the overhead surcharge was not recognised as a tax expense.
- The Municipal Court in Prague sided with the tax administrator.
- According to the Court, the negotiation of a lump sum price is not excluded, but it is up to the taxpayer to prove that it was incurred for the purpose of generating, assuring and maintaining income.
- According to the Court, the company did not provide any documentation in the tax proceedings to establish how the company determined the supplier's overhead costs and how these costs related to the overhead surcharge.

So we will see what this case will eventually bring in the next round. This is yet another judgment that shows that proving intra-group services is a tricky issue and the demands of the tax administration (and the courts) tend to increase over time.

If you are interested in this area, please contact the author of the article or your usual EY team.

According to the tax administrator, the lump sum compensation cannot be determined on the basis of an estimate alone without the necessary documents - the calculation for determining the lump sum must, according to the tax administrator, be broken down and supported by documents at any time.

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Interpretation of a Double Tax Treaty by the Municipal Court in Prague

In this issue, we bring you an interesting judgment of the Municipal Court in Prague dealing with the classification of income from aircraft rental (without crew) under the previous version of the Czech-Korean double tax treaty.

Background

- A Czech company (airline) leased an aircraft (and engine) from a Korean company (also an airline).
- The dispute was over the classification and related taxation of income from this lease agreement under the then applicable (2018) Double Tax Treaty between the Czech Republic and Korea ("Old DTT").
- The tax administration was of the opinion that the income in question was subject to a 10% Czech withholding tax in accordance with the Income Tax Act (ITA) and Article 12(2) of the Old DTT.
- In contrast, the Czech company (i.e. the taxpayer) was of the opinion that the income from the lease of the aircraft was profit from the operation of the aircraft in international transport according to Article 8 of the Old DTT and therefore should not be subject to taxation in the Czech Republic.

View of the Court

The Municipal Court sided with the tax administration – below are some of its arguments:

- First of all, the Court stated that the income in the case at hand was income under § 22(1)(g)(5) of the ITA, i.e. income from the use of movable property or part thereof located in the Czech Republic, which is subject to a special tax rate in accordance with § 36(1)(a) of the ITA. [Author's note: the judgment unfortunately does not elaborate on the interpretation of the term "located in the territory of the Czech Republic" and the related possible consideration of the location of an aircraft used in international transport at least partly outside the territory of the Czech Republic.]
- The Court further found that the OECD Model Treaty and its Commentary had undergone gradual development and refinement. According to the Court, the versions of the Model Treaty and the Commentary that existed at the time of signing of the Old DTT, i.e. 27

April 1992, are primarily relevant for the interpretation of the Old DTT, not the subsequent modifications.

- According to the Court, the definition of royalties in Article 12(3) of the Old DTT corresponds to that of the 1977 OECD Model Treaty, except that the Contracting Parties expressly agreed in Article 12(2) of the Old DTT to tax income from the rental of equipment also in the Contracting State in which the source of that income is located. By agreeing to this option, the parties expressly departed from the 1977 OECD Model Treaty, which did not allow taxation in the source state.

- According to the Court, it is clear that the income from the lease of the aircraft and the engine falls within the scope of Article 12(3)(a) of the old DTT. However, this is not sufficient to decide the case. Were the income from the lease of an aircraft also covered by Article 8 of the old DTT, it would be necessary to resolve this conflict and interpret which of the possible interpretations should be followed. The Court therefore went on to consider the interpretation of Article 8 of the old DTT.

- Article 8 of the old DTT regulates profits from the operation of aircraft in international transport. According to the Court, a mere interpretation of the language does not lead to the conclusion that profits from the rental of an aircraft are income from the operation of an aircraft which would fall within the scope of Article 8 of the Old DTT. However, the Court noted that the OECD Model Treaty Commentary interprets the profit from the operation of aircraft in a more expansive manner. It therefore considered what effect this had on the interpretation of the Old DTT.

- In this context, the Court reviewed historical versions of the Commentary to the OECD Model Treaty, noting that the scope of income covering profits from the operation of aircraft is not clear-cut and that its interpretation has undergone a major transformation since the 1963 Draft Double Tax and Property Treaty into the 2005 OECD Model Treaty, with a clear tendency to expand the income covered by Article 8. However, at the time of the signing of the Old DTT, even according to the Commentary to the OECD Model Treaty, the concept did not have the broad scope that it has had since 2005. Although the Commentary current at the time of the signing of the Old DTT explicitly included occasional income from the chartering of unmanned aircraft under Article 8, it did not explain why this change from the previous version of the Commentary was made and introduced the criterion of occasionality in a completely unsystematic way and only for the chartering of unmanned aircraft. It was only in 2005 that the Commentary clarified and justified more precisely why income of a supplementary nature should be included under Article 8 alongside closely related income. In line with this change, there is also a terminological alignment and, for the chartering of an unmanned aircraft, the Commentary now refers not to occasional income but to supplementary income in the same way as for other cases.

- The Court also deemed it appropriate in this context to look at other double tax treaties that the Czech Republic has adopted, concluding that the Czech Republic has long made a distinction as to whether or not it includes income from the rental of unmanned aircraft under Article 8. If it wishes to do so, it will negotiate this arrangement explicitly.

- In conjunction with the practice of the Czech Republic, which has long and consistently departed from the OECD Model Treaty and includes in the definition of royalties in double tax treaties also income from the lease of industrial, commercial and scientific equipment, according to the Court, it is clear that the Czech Republic generally wishes to tax income from the rental of unmanned aircraft (and other equipment) also in the source State, unless it expressly agrees otherwise with the other State in Article 8, and it is irrelevant that, unlike Slovakia, it did not make a reservation to Article 8 of the OECD Model Treaty.

- The Czech Republic and the Republic of Korea did not explicitly include income from the rental of unmanned aircraft under Article 8 of the old DTT, though both the Czech Republic and the Republic of Korea do so in many cases. They only included this income under Article 8 in the new 2020 DTT. This new amendment supports the conclusion that the old DTT did not include this income under Article 8. Indeed, if it had been included earlier in the treaty, there would have been no need to amend Article 8. This part, notwithstanding the provisions of Article 12, also supports the conclusion that the new DTT newly exempts aircraft rental income from the scope of this Article. Finally, the part of the Submission Report stating that the Old DTT "no longer fully corresponds to the current conditions and for this reason the competent authorities of both countries have agreed to its total renegotiation" is evidence that the intention was to change the tax regime, not to confirm the existing one.

- Accordingly, the Court concluded that the expansive interpretation in the Commentary to the 1977 OECD Model Treaty, while subsuming occasional income from the rental of an unmanned aircraft under profits from the operation of the aircraft, did not explain why it departed from its earlier version and the newly introduced category of occasional income was not consistent with the rest of the Commentary. According to the Court, therefore, the mere unjustified mention in the Commentary does not constitute a reason for extending the interpretation of Article 8 of the Old DTT beyond its linguistic scope.

Courts in the Czech Republic generally do not often engage in a detailed analysis of double tax treaties. In this case, the Court embarked on a truly detailed analysis and its reasoning shows that the Model Treaty Commentary should be treated with caution.

We would like to point out that it is not clear from the available information whether the taxpayer or the tax administrator dealt with the question of to what extent the aircraft was actually used in the territory of the Czech Republic and to what extent in airspace outside the Czech Republic and whether this criterion is relevant for determining the source of income and the application of withholding tax. We can only speculate that it was the practical difficulties in determining this range that led to the interpretation contained in the Model Treaty and the subsequent amendment of the DTT.

If you are interested in this area, please contact the author of the article or your usual EY team.

The Czech Republic and the Republic of Korea did not explicitly include income from the rental of unmanned aircraft under Article 8 of the old DTT, though the Czech Republic and the Republic of Korea do so in many cases. It is only in the new 2020 DTT that they have included this income under Article 8. This new amendment supports the conclusion that the Old DTT did not include such income under Article 8.

For further information please contact either your usual partner or manager.

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- The sale of wrecked vehicles by an insurance company cannot be considered a VAT-exempt insurance activity?
- A single work contract does not necessarily mean a single supply for VAT purposes?
- Changes are coming for big business in the area of energy price capping?
- The Supreme Administrative Court commented on crown bonds and the issue of abuse?