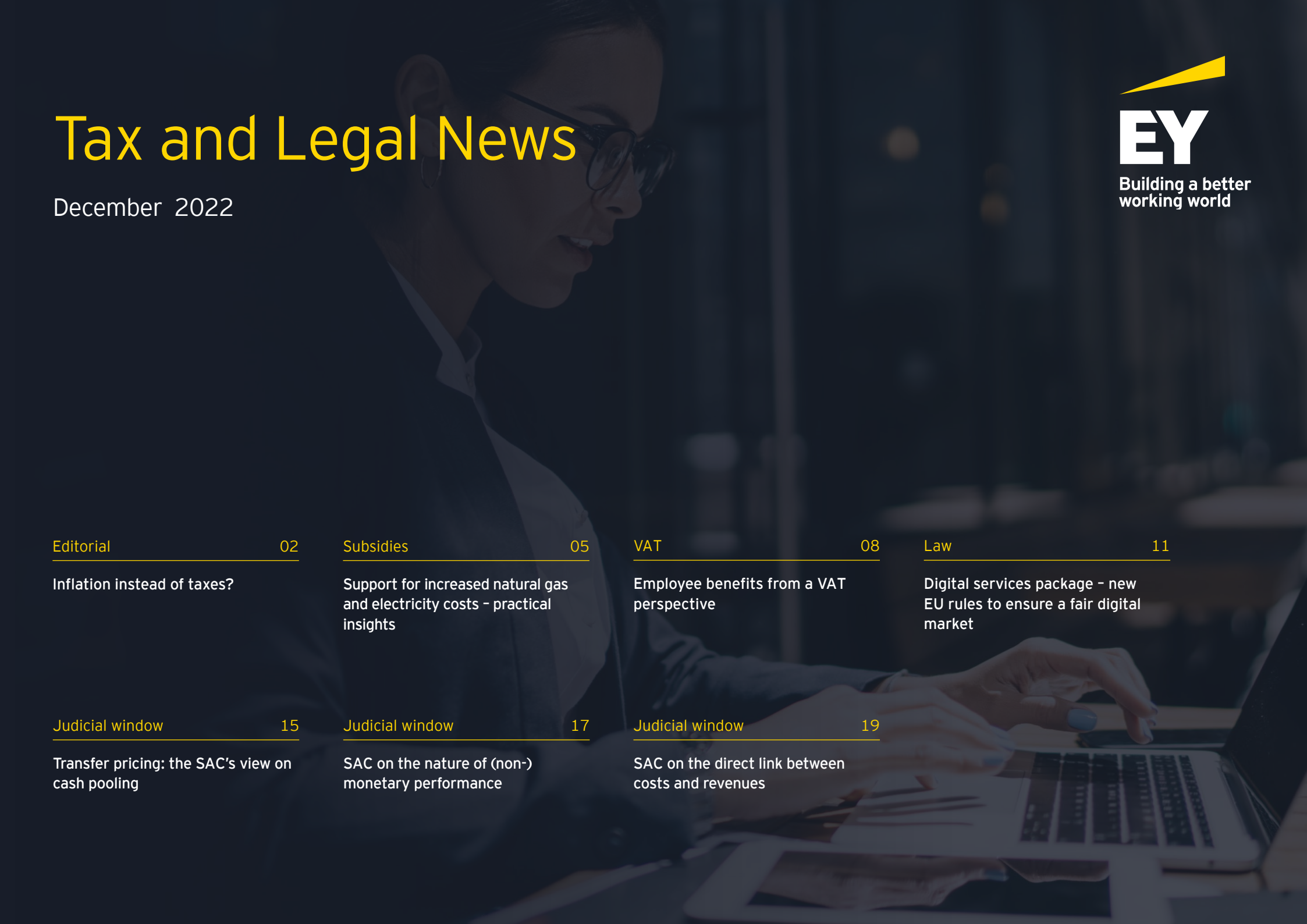
Tax and Legal News

December 2022



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Inflation instead of taxes?

In March 2021, our editorial reflected on possible future post-pandemic tax reforms. Peripherally, more as an academic excursion into the history of tax theory and policy in (post)crisis periods, we mentioned the war profits tax and the war surcharge of 1916.

So this time, I'd rather focus on a tax that's been around for a long time, though it technically doesn't meet the constitutional requirement of Article 11(5) of the Charter of Fundamental Rights and Freedoms, which states that taxes and fees can only be imposed by law. (I will leave for later a detailed analysis as to whether the newly approved windfall profits tax passes the constitutionality test.)

Let's look at the so-called inflation tax, a concept introduced and first comprehensively presented in 1924 in the work of the eminent 20th century economist John Maynard Keynes, A Tract on Monetary Reform, in the chapter "Inflation as a Method of Taxation". The income of the state from the issue of money was defined by Keynes as a tax: "The government can in this way [by printing money] secure the disposition of real resources, resources just as real as those it obtains by taxation. ... A government can live by this means when it can live by no other. It is the form of taxation that is most difficult to escape, as the public knows, and which the weakest government can impose when it can impose nothing else."

Rising government spending and the associated monetization of government debt (e.g. by issuing government bonds) leads to inflation due to the increasing amount of money in the economy, i.e. a decline in the real value of money balances. This depreciation is simply an inflation tax (although economic studies and models are much more complicated and vary in their exact definitions). At first sight, an inflation tax resembles a general consumption tax or a flat-rate income tax and should thus fall on taxpayers roughly in direct proportion to their wealth. Adam Smith would rejoice at the principle of justice fulfilled. The problem, however, is the rigidity of some prices, slower wage increases and retirement pensions, which leads to a rather regressive impact of this tax. It also typically favours the borrower over the lender because inflation expectations are not perfectly reflected.

The current high rate of inflation is clearly having a positive effect on the level of tax revenue collected, with most tax bases rising due to inflation. Of course, the expenditure side of the budget is also growing, albeit typically at a slower pace. However, if the resulting deficit can be kept relatively stable (economists estimate CZK 250-300 billion per year for the Czech Republic), then high inflation itself will have a significant positive impact on the stabilisation of public finances in this and the coming years. The key indicator of the budget deficit-to-GDP ratio (one of the Maastricht criteria, targeted below 3%) will automatically improve due to an inflationary increase in the GDP value in the denominator. And that's without the need for unpopular spending cuts or tax increases in the numerator. We will pay for it with

that less visible inflation tax. No tax return, no payment assessment, no constitutional complaints (and no tax advisor).

The constitutionality of the inflation tax was also considered by Supreme Administrative Court President JUDr. Šimka at the September seminar of the Supreme Administrative Court and the Chamber of Tax Advisors during the discussion of the taxation of the increase in the value of assets caused by the exchange rate difference for an individual (approved by a relatively controversial and debated judgment of the Supreme Administrative Court).

Finally, let me mention the emerging thoughts about the possibility of replacing tax collection entirely by inflation. This is a revolutionary idea. Of course, high inflation is not good for the economy. But neither is a high level of taxation. People are annoyed by both high inflation and high taxes. There's a limit to the maximum amount of money the state can raise through inflation. The same is true of tax collection. So far, however, conventional taxation is winning. It is more predictable. Tested and studied for years. In our economies, we know how to operate in a tax environment rather than a high inflation environment. Tradition is tradition.

We wish everyone a wonderful Advent, full (not only of) tax traditions.

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Subsidies

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Support for increased natural gas and electricity costs – practical insights

In our Subsidy Alerts (available here, here and here), we have kept you informed about the basic parameters of the support for the increased costs of natural gas and electricity due to the exceptionally sharp rise in their prices. The Ministry of Industry and Trade (the Ministry) published the final version of the Call for Proposals on 2 November 2022, followed by the preparation of Amendment No. 1 on 11 November 2022 (available here), and then published a further Amendment No. 2 on 30 November 2022 (available here). You can read the Call as amended by the two addenda here.

Below, we would like to share some practical insights that have emerged from our discussions and ongoing communication with Ministry representatives during the preparation of applications:

- The first applications have already been submitted. However, their ranking will be determined after checking and confirming that all the requirements have been met (formal check). Only when the application is complete will it be included in the ranking of supported applications.
- The widely discussed condition of waiver of remuneration by the statutory body is interpreted by the Ministry's representatives as meaning that if the remuneration (including the variable part) is already contractually fixed, it can be paid, but it may not be increased subsequently (after the application is submitted). If the remuneration is not contractually fixed, the remuneration may not be increased from the previous financial year.
- The addendum to the Call may, to some extent, resolve interpretative ambiguities for foreign statutory bodies who work only partially for a Czech applicant for subsidy and have (most of) their remuneration paid by a foreign person.
- A number of applicants still do not have up-to-date information in their beneficial owner records (for more, see our Alert here), which can slow the completion and submission of applications.

- In case of monthly cost reporting, it is necessary to obtain confirmation from the auditor including the auditor's report according to the terms of the Call. For summary reporting, either an auditor's confirmation can be provided or a supplier's confirmation that includes consumption and cost (excluding distribution and other charges). Some large suppliers have a reserved approach to issuing confirmations, and applicants therefore deal with the auditor for verification, again delaying the completion and submission of the application.

- Another important point is the exchange rate if you have invoices in a currency other than Czech crowns. The invoice usually shows the exchange rate on the date of the taxable transaction. However, for the calculation of eligible expenditure, the exchange rate on the date of the invoice must be used.

- No less importantly, care must be taken with the data entered in the eligible costs calculator. Many applicants fail to note that the eligible costs are calculated on the basis of costs exclusive of regulated items.

- You cannot apply if you are buying energy and gas from an intermediary who is not also licensed to trade in energy (typically the owner of property you are renting).

- Many of you still have electricity and gas prices fixed for 2022 and so do not qualify for support under the Call (costs for February to October 2022 can be supported if their price increase was more than double). The Ministry and the Government are currently discussing the form of support for costs to be incurred in 2023 (price caps for large companies are also in play); no decision had been made at the time of writing.

Some potential applicants are also considering whether they will be subject to Government Decree No. 298 Coll. of 5 October 2022 on the determination of electricity and gas prices in an exceptional market situation, as amended (so-called price caps), or whether they will be able to apply for support under the Call. In some specific situations, assessing whether they meet the criteria for an SME can be quite complicated – our legal specialists have extensive practical experience in this area.

Finally, let us reiterate that for the lowest category of aid (30% of qualifying costs, maximum CZK 45 million), achieving an operating loss is not a prerequisite. Higher aid levels (50% and 70%) are available for energy-intensive enterprises and enterprises in selected sectors, subject (in addition to other requirements for eligible applicants) to the achievement of an operating loss (EBITDA < 0) and eligible costs must represent at least 50% of the operating loss.

According to Amendment No. 2, applications can be submitted until midnight on 8 February 2023; however, the Ministry reserves the right to terminate the receipt of applications for support early, especially in the event of exhaustion of the Call allocation (CZK 30 billion).

If you are interested in this area, or if you are considering preparing a grant application and would like help, please contact the authors of this article or your usual EY team.

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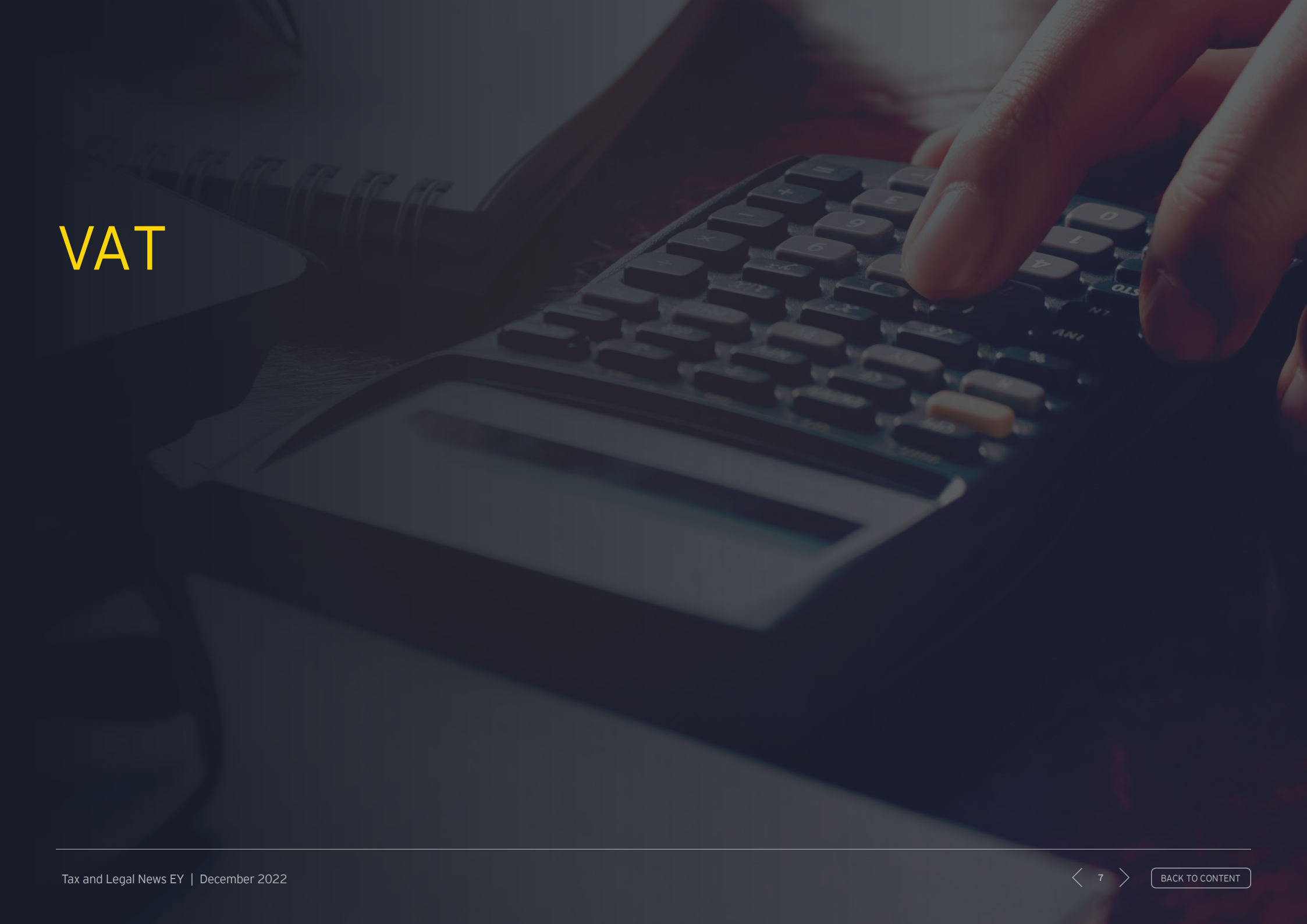
VAT



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Employee benefits from a VAT perspective

Our clients are getting more and more creative when it comes to employee benefits. We're right there with them, and love finding new solutions to your challenges. Tax-efficient solutions should be set up in advance. Looking for the right tax solution after the benefit has already been provided to the employee may not yield the best result. To give a simple example: an employer contributes to an employee's language course.

Although less may be sufficient for preferential treatment from an income tax perspective (see "The SAC on the nature of (non-)monetary benefits" at the end of this issue), from a VAT perspective the following solutions may arise depending on the contractual set-up of the employer:

- the employee pays for the course and only receives a financial contribution from the employer outside the scope of VAT;
- the agency provides the course directly to the employee and the employer pays for all or part of it (third-party payment);
- the employer purchases the course, claims the VAT deduction and provides the employee with a discount;
- the employer purchases the course, deducts VAT and does not apply output VAT because the employee needs the course for work purposes.

Below are the three main questions you should answer when determining the VAT treatment of employee benefits.

Who is the provider?

The first step is to determine whether the employer is providing the employee with a supply itself or merely contributing financially to a supply from another person. An employer may negotiate better prices for goods and services for its employees with another company. Although the employee may perceive this as a benefit from the employer, in reality the employer has not provided anything directly to the employee. If the employer matches the cost of a third-party supply to the employee, the employer's contribution may constitute third-party consideration that enters into the tax base of the supply in question. The employer cannot claim a VAT deduction because it did not receive the supply.

If the employer purchases goods and services and then provides them to employees on its behalf, the following questions should be asked.

Does the employee contribute to the benefit?

If an employer provides goods or services to employees for consideration, such

provision is always subject to VAT (unless the supply is exempt from VAT). If the employer deducts a contribution from the employee's wages for the supply, the employer should deduct it in the amount including VAT and pay this tax.

The fee from the employee does not necessarily cover the employer's costs, but at the same time should not be purely symbolic.

This is typically the case with subsidised lunches, discounted SIM cards for family members or fuel allowances for employees on private journeys. In the case of 're-sales' to employees, the question of the correct place of taxation and VAT rate may arise. A company car used for private purposes by foreign employees may constitute a rental vehicle subject to taxation in their country of residence. Food delivered to the company's loading dock in a cooker will have a different VAT rate than food subsequently served to employees in the canteen.

In practice, we also often see various extra payments to employees for a better company phone, better work aids or extra car equipment. The taxation of such allowances depends primarily on the legal title to the item paid. If the premium equipment remains part of the employer's business assets and cannot be transferred to the employee in any way, then it is probably a taxable service (the possibility of using better equipment).

Applying VAT to the contribution paid by the employee to the employer significantly improves the position for claiming VAT deductions on the related inputs.

Is the free benefit related to the employer's economic activity?

If the answer to this question is no, the benefit will normally be subject to VAT. The employer has the choice of applying a proportional input tax deduction or a full tax deduction combined with the taxation of private consumption at the output (except for the acquisition of fixed assets).

Generally, a free benefit is less tax advantageous for the employer than a benefit with a contribution from the employee. However, if a company still chooses this option, it can achieve more efficient taxation by, for example, timing the inclusion of fixed assets in use or appropriate contractual documentation.

In the case of taxation, a distinction must be made between goods and services. In the case of a permanent transfer of business assets to an employee, VAT will almost always be chargeable. The determination of the tax base for such a supply, in particular the rate of wear and tear of the donated goods, may be crucial.

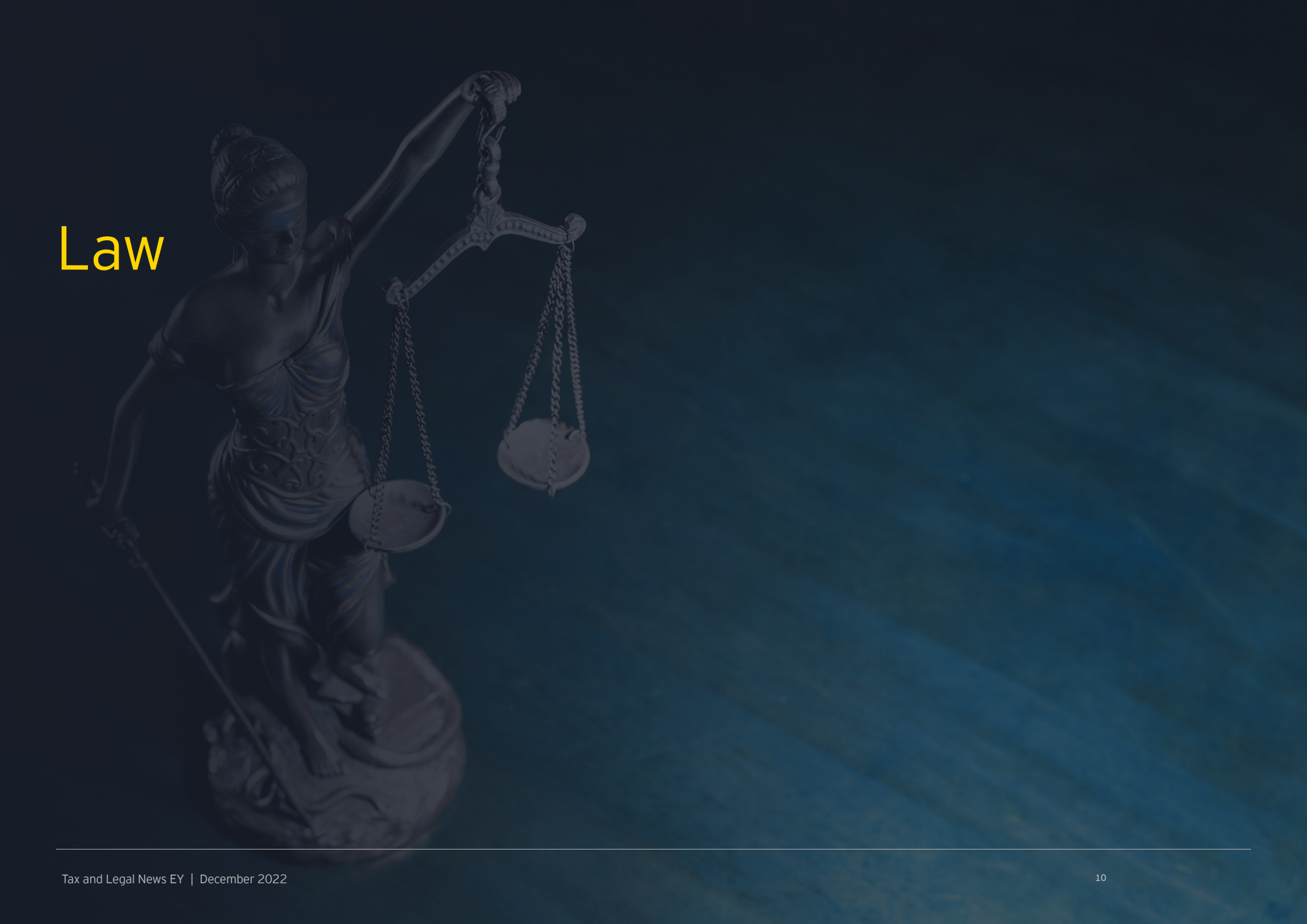
The situation may be more favourable for services. We already know from European case law that some services provided free of charge to employees do not constitute private consumption (e.g. transport of employees to remote workplaces, meals at work meetings) because the employer's economic interest prevails. In the case of a temporary use of company property (i.e. a service), the employer must ensure that the property actually returns to its disposal at a later date. In our opinion, the above-standard equipment of office premises (various relaxation zones, table tennis, gym, etc.) should not automatically be considered as personal consumption of employees. However, in order to qualify for the tax deduction, employers must be prepared to justify that such equipment motivates employees to perform better at work.

Finally, it should be noted that the VAT paid may in some cases be a tax deductible expense for income tax purposes.

If you have any questions, we will be happy to discuss the setup of employee benefits in your company. If you have any questions about the above topic, please contact the authors or your usual EY team.

When goods and services are purchased by an employer and provided on its behalf to employees, several questions need to be asked.

Law



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Digital services package – new EU rules to ensure a fair digital market

This autumn, the European Union adopted a long-awaited package of regulations aimed at reforming the online environment in which companies offer and use digital services in its internal market.

The Digital Service Package consists of two parts and creates a single European legal framework defining the obligations and responsibilities of digital service providers. The Digital Services Regulation primarily affects providers of intermediated services and aims to harmonise the rules for regulating digital platforms in a way that ensures a safer digital environment with greater emphasis on protecting users' rights. In particular, the Digital Markets Regulation brings a fairer playing field for smaller and medium-sized businesses and end-users, more open competition in the digital environment and control over the digital market.

Digital Services Regulation

The Digital Services Regulation will apply to all online intermediary services (e.g. social networks, online marketplaces, web hosting services, etc.) offered in the EU single market, as long as the recipients are established or resident in the territory of the Union. The place of establishment of the recipients of the services is therefore decisive, not that of the online intermediary.

The new rules are primarily aimed at ensuring better competitiveness of small and medium-sized enterprises, which account for more than 90% of all platforms in the EU. The obligations of online intermediaries are proportionally balanced in relation to their size. This means that small and micro enterprises are exempted from some obligations so as not to be disproportionately burdened.

The Regulation is relevant not only for all online service providers, but also for their users (whether consumers or businesses). It focuses in particular on the removal of illegal and harmful digital content, the liability of online intermediaries for content provided by third parties and the protection of users' fundamental rights in the online environment. Among other things, the Regulation introduces and harmonises:

- Modified liability regime for online intermediaries for illegal content. The amendment introduces an obligation for hosting providers or online platforms to put in place user-friendly mechanisms to flag illegal content or goods. In addition, businesses will have to set up an internal system for receiving complaints.

- Transparent obligations for intermediary service providers regarding the measures they take to moderate digital content. If a platform decides to remove digital content, it must provide an explanation to the person who uploaded the content.

- Know Your Business Customer rules requiring platforms to obtain and verify information about business partners (e.g. retail companies) before allowing them to use their services. For distance contracting between traders and consumers, the interface of the platform should allow traders to fulfil their obligation to inform consumers about the safety of the product they offer, leading to better consumer awareness of the actual sellers of products/service providers.

- Transparency regarding online advertising and the algorithm used to recommend content. Platforms will need to state sufficiently and clearly in their terms of service the main parameters used in their recommendation systems (i.e. the systems on which they target advertising) and the potential ability of recipients of the service to change or influence these main parameters.

In our opinion, the unification of European legislation can be evaluated positively, as it should also be reflected in a reduction of the administrative burden on the entrepreneurs concerned. At present, legislation is fragmented within the EU and companies providing digital services in several countries have to deal with different national regulations in each Member State.

Member States must ensure that the maximum amount of fines for infringements is up to 6% of annual income or turnover. Continuous infringements may be punishable by a repeatable fine of up to 5% of the average daily turnover (determined from the dates of the previous financial year) per day.

The Regulation entered into force on the twentieth day following its publication in the Official Journal of the EU, 16 November 2022, and will apply from 17 February 2024.

Digital Markets Regulation

The Regulation comprehensively regulates the biggest players in the digital market. It focuses primarily on companies known as "gatekeepers". These companies, through their strong economic position, can create market barriers that prevent entrepreneurs and users from accessing the digital world without relying on gatekeepers, thereby potentially influencing the relevant market (e.g. Google, YouTube, Amazon, Meta). The legislation aims to ensure that gatekeepers in the online digital environment follow fair rules when providing their services, which will affect not only consumers but also other entrepreneurs who use the platforms in their business.

The gatekeepers are determined on the basis of objective criteria, which will generally be met by the major online platforms. These criteria reflect their strong economic position through which they can significantly influence the performance of the EU internal market. Another condition is their strong intermediary position, through which they connect a large number of entities with their extensive user base. The last condition is that the above-mentioned influence should ensure them a permanent and established market position.

In particular, companies operating internet search engines (Google Search), communication tools (Meta), video sharing platforms (YouTube) and other online applications (Apple, Amazon) will meet these criteria. Indeed, gatekeepers can use their dominant position to create a market barrier preventing entrepreneurs and users from accessing the digital world without depending on these companies (e.g. Apple's recently discussed 30% fee from mobile app sales). This dependency is often triggered today by the fact that entrepreneurs or users entering the digital environment have to use the services of these gatekeepers, as these services are often specific and incompatible with those of other players in the digital market. This paves the way for unfair market practices by gatekeepers.

The Regulation will prevent gatekeepers from applying unfair practices to businesses using their services and thereby gaining undue advantage. Thus, gatekeepers will not be able to favour their own services by setting rules

that give consumers preferential exposure to the products and services they offer, thereby making it more difficult for competitors to reach customers. Consumers will be shown the best products and services available, not just those preferred by dominant platforms.

Gatekeepers should also allow their business users to offer the same products or services to end-users through third-party online intermediary services on terms that may differ from those offered through the gatekeeper. This is reflected in the prohibition of so-called 'most-favoured clauses', which oblige the obliged party to provide the beneficiary party with all the advantages it grants to third-party competitors. These clauses are mainly used in the accommodation brokerage business to prohibit hotels from offering their accommodation services at lower prices on other sales outlets or online platforms. The gatekeepers will also have to allow their business users to offer their services and enter into contracts with the customers they broker outside the gatekeepers' platform. This means that they will not be able to prevent consumers from connecting with businesses outside their platform.

Companies will also not be able to make it impossible to download their own apps from a source other than their own repository (for example, Apple will have to offer its online products on platforms other than the App Store).

Violations should be punishable by a fine of up to 20% of the gatekeeper's worldwide turnover.

The Regulation entered into force on the twentieth day following its publication in the Official Journal of the European Union, 1 November 2022, and will come into force on 2 May 2023.

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

The Digital Services Regulation package sets out a single European legal framework for doing business in the digital environment. In addition to ensuring a safer digital environment with a greater focus on protecting users' rights, it aims to reduce the dominance of the largest online platforms, which often resort to unfair practices, and thus ensure a fairer and more balanced internal market.

Judicial window

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Transfer pricing: the SAC's view on cash pooling

The Supreme Administrative Court (SAC) recently issued an interesting judgment regarding the setting of interest rates in a group cash pool.

Background

- A company, a retailer of roofing and insulation accessories, entered into a cash pool agreement with its parent company in 2009. Deposits bore interest at 1M PRIBOR + 3%, any borrowings from the shared account bore interest at 1M PRIBOR + 3.75%.
- In 2012, a new agreement was concluded under which deposits bore interest at 1M PRIBOR + 0.17% and loans at 1M PRIBOR + 4.5%. In addition to the significant change in interest rates, the way the cash pool operates also changed. It was now run automatically on a daily basis, thanks to which the Czech company saved CZK 100-150 thousand a year in bank fees and benefited from immediate interest on deposits.

Subject of the dispute

- The tax administrator initiated an audit of the 2012 tax year and asked the company several times to explain the difference between the original and the new interest rate on deposits.
- The company explained to the tax authorities on several occasions that the interest margins were always determined on the basis of the financial position of the entire group and that the new margin relating to cash pool deposits (+0.17%) was based on the average deposit margin of several banks in 2010. Given the change in the operation of the cash pool, even this low interest rate was more advantageous to the company than the rate it would have received for a similar product from the bank as a stand-alone unit.
- The company also submitted an expert opinion prepared during the tax audit, which stated that the most comparable to a cash pool is a bank account for corporate needs or a savings account (under certain conditions). For 2012, the average interest rate for corporate bank accounts was 0.19 % p.a..
- The tax administrator refused to accept the conclusions of the expert's report, arguing that the cash pooling account was not comparable to regular bank accounts.
- By contrast, the tax administrator considered the originally set rate to be market-based because it allowed the cash pool manager to cover costs and make a reasonable profit.

- The tax administrator concluded that the company had not satisfactorily explained the difference between the original and the new rate and used the original rate as a market reference for the tax assessment (CZK 145 thousand and CZK 29 thousand in penalties).

View of the SAC

- The SAC held that the mere reduction in the interest rate granted on cash pool deposits should not have led to an adjustment of the tax base.
- In tax proceedings, the general principle is that the taxpayer itself bears the burden of proof in relation to its allegations concerning its tax liability. However, in the case of evidence of market price, this general rule does not apply and the burden of proof lies with the tax administrator.
- The SAC states that the tax authorities should have focused not on the fact that the interest rate was reduced, but on establishing how much the deposits would have earned interest if the persons were not connected. It should have addressed this question to the providers of similar products (i.e. the banks) or to an expert.
- The SAC agrees with the tax administrator's assertion that a cash pooling account cannot be considered a product fully comparable to regular bank accounts. However, it disagrees with the finding that bank accounts cannot be compared at all, since at least at their core the accounts offered by banks are comparable.
- The tax administrator erroneously identified the original rate of 1M PRIBOR + 3% as the 'benchmark rate'. However, this rate is a rate negotiated between related parties and thus cannot be a benchmark.
- Thus, the tax administrator did not carry its burden of proof to prove that the prices negotiated between related and independent parties were different.

"Although the difference between the original and the new rate for cash pool deposits negotiated between the same entities may be taken as an indication that the newly negotiated substantially lower rate may have been for the purpose of tax evasion, it is still the tax administrator who bears the burden of proof as to the established difference between the negotiated and comparative rates...".

Conclusion

A change in transfer pricing settings is an indication to the tax authorities that either the original or the new settings are in breach of the arm's length principle, and often leads to the initiation of a tax audit, but cannot in itself lead to a tax assessment.

If you have any questions, please contact either the authors of the article or your usual EY team.

A change in transfer price settings is an indication to the tax authorities that either the original or the new settings are in breach of the arm's length principle, and often leads to the initiation of a tax audit, but it cannot in itself lead to a tax assessment.

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SAC on the nature of (non-)monetary performance

The SAC dealt with the question whether funds provided by an employer to an employee for recreational purposes can be considered an in-kind benefit within the meaning of the Income Tax Act (ITA).

The company provided two of its employees with recreational funds of CZK 3,000 each. The company considered this benefit to be exempt from employment income tax (and, by analogy, from social security and health insurance), citing § 6(9)(d) of the ITA.

The Czech Social Security Administration (CSSA) rejected such argumentation in the course of its review and levied the company with the insurance premium and penalties because, in its opinion, it was undoubtedly a monetary contribution that is not subject to tax exemption under the above-mentioned provision of the ITA. The company brought an administrative action against the decision of the CSSA.

In its assessment of the case, the Regional Court in Brno (RC) found in favour of the company, concluding that the employer fulfilled the conditions of § 6(9)(d) of the ITA, since even in the case of the provision of money, it may be an in-kind benefit in certain cases, if the contribution is earmarked for the acquisition of certain goods or services. At the same time, the RC used the provisions of § 6(7)(c) of the ITA as a supporting argument, from which, according to the RC, it follows that not every amount of money received by an employee from an employer is income of the employee that would be subject to tax.

The SAC, however, did not share the opinion of the RC and upheld the opinion of the CSSA. Selected arguments of the SAC are summarized below:

- The Regional Court's interpretation essentially blurs the distinction between the purpose of the performance and the form in which the performance was provided, and emphasises the defined purpose above all. Such an approach, however, does not correspond to the applicable legislation.
- By the nature of the matter, an in-kind benefit is to be considered as such a benefit which is not provided in money, virtually not even exchangeable for money or other similar means or benefits. Although the ITA does not define this concept in detail, it appears to be absolutely unambiguous.
- In-kind benefits in this sense are those where the employer pays a sum of money to a person other than the employee and his or her family member (provided the employer is not the provider of the recreational facility directly) and the employer provides a benefit or service to those persons (both prospectively and, in certain circumstances,

retrospectively). The only way to achieve 'employer-provided recreation' is for the employer to provide or arrange for a ready-made service, which is a recreational activity or trip.

- Assuming that the employer provides a sum of money for payment, albeit for a specific purpose, the fulfilment of that purpose is not guaranteed at the time it is provided and it is purely at the employee's discretion whether to use the 'extra' money specifically for recreation. It is irrelevant that the actual use for recreation occurred in this case (whether the recreation funds directly provided were actually used for recreation or whether the recreation was paid for out of other funds of the employee in question cannot be ascertained in view of the money's nature).

- Essentially, if the benefit is provided in the form of funds, the disposition of the funds is not effectively restricted and it is a standard part of the salary, i.e. taxable income subject to taxation and social insurance.

- It must therefore be concluded that the disputed supply is a monetary supply, which means that the conditions for exemption from income tax within the meaning of § 6(9)(d) of the Income Tax Act cannot be met.

- The provision of § 6(7)(c) of the ITA speaks of amounts received by an employee in advance from an employer to be spent on behalf of the employer or amounts of reimbursement for proven expenses by the employee that are for the benefit of the employer (as if incurred by the employer itself) from which the employee does not benefit. However, these benefits are not at issue in the present case. The employer did not provide any advance payments to the employees or reimbursements for proven expenses, nor is there any indication that the employer authorized the employees to make purchases on its behalf. Therefore, the applicability of this provision cannot be considered.

- Moreover, the provision of § 6(7)(c) of the ITA deals with types of transactions that are not subject to tax, as no benefit accrues to the employee. In contrast, § 6(9)(d) deals with types of transactions which benefit the employee but which the legislator, with some intention, exempts from tax.

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

According to the SAC, by the nature of the case, an in-kind benefit should be considered as a benefit that is not provided in money, or is not even exchangeable for money or other similar means or benefits. Although the ITA does not define this concept in detail, it appears to be absolutely unambiguous.

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SAC on the direct link between costs and revenues

We bring you a recent judgment of the SAC on the application of § 24(2)(zc) of the ITA as amended until the end of 2014, which is also an important topic for the current version of the ITA.

Background:

- The company submitted contracts for selected transactions with external customers and only some of them showed general arrangements for the reimbursement of travel expenses of persons representing the customer in connection with the acceptance of goods. Similar general provisions were contained in the terms and conditions, the contract proposal, the award of the tender or the invitation to tender.
- In this context, the company incurred various representation costs (accommodation, meals, entertainment, air tickets, vehicle rentals, rental of movable property, contracting services, per diems, taxis, museum entrance fees, etc.) during the acceptance of goods on behalf of its business partners, which, with reference to § 24(2)(zc) of the ITA as amended until the end of 2014, were considered tax deductible.

View of the tax administrator:

- The inclusion of only estimated (not actually incurred) representation costs in the price quotation between the company and its supplier does not result in their 'transformation' into tax deductible costs.
- The general provisions on the obligation to pay representation expenses contained only in some of the contracts, contractual terms, contract proposal, etc. do not prove a real direct and material connection. There are no specific provisions on the inclusion of expenses for the acceptance of goods in the contracts concluded with customers.
- The method of pricing (what will be included in the calculation) is not decisive for finding a direct link.

View of the Regional Court:

- If the company documented during the tax audit the amount of costs for the acceptance of goods (for representation) in relation to a specific business case (and the contracts for the individual transactions contained a voluntary arrangement according to which the company bore them), it is difficult to conclude on the basis of § 24(2)(zc) of the ITA as in force until 31 December 2014 that there was no direct link between these costs and the proceeds from the sale of goods.

View of the SAC:

- A direct link between costs and revenues cannot be inferred from the facts alleged and proved by the company.
- The inclusion of representation costs paid on behalf of business partners in the calculation of the invoice price does not establish a direct link between specific costs and specific revenues.
- In fact, the reference to the pricing method merely demonstrates sound economic reasoning in pricing, according to which all the costs incurred by the company are covered by the resulting price of the traded product. However, this is not relevant for income tax purposes.
- In order for representation costs paid on behalf of customer representatives to be deductible for tax purposes, the company would have to prove not only in relation to which business case they were incurred, but also that without them (i.e. without specific refreshments, taxi reimbursement, beauty services, etc.) the customer would not have purchased the goods, or not on the terms they did. However, it has failed to demonstrate this in the transactions under review.

If you have any questions, please contact the author of the article or your usual EY team.

According to the SAC, the inclusion of representation costs paid on behalf of business partners in the calculation of the invoiced price does not establish a direct link between specific costs and specific revenues.

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

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Did you know:

- Possible implementation of Pillar 2 of BEPS 2.0 could have significant tax implications?
- The Ministry of Labour and Social Affairs has submitted a long-awaited amendment of the Employment Act?
- The GFD published information on the increase in turnover for VAT registration?
- An amendment of the Income Tax Act and VAT Act was published in the Collection of Laws?