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Ready for the New Year, or what tax administrators (also) like to do

The new year is upon us and there is so much new to write about – benefits, functional currency, new VAT rates, windfall profits tax, top-up tax and related tax (administrative and monetary) obligations…

However, I would like to stop at the imaginary pinnacle of tax practice, which is undoubtedly the tax audit activity of the tax administration and several topics that tax administrators deal with (and how they are subsequently successful in administrative courts).

I'll leave out real and perceived VAT fraud, proving management, advertising and intermediary services, beneficial ownership and abuse of law, and I'd like to elaborate on one obvious evergreen, and one overlooked, topic.

The obvious one is, unsurprisingly, transfer prices. After awakening from their COVID hibernation, the tax authorities have embarked with their own zeal on a whole series of audits, examining the results of loss-making, under- (and in the case of investment incentive recipients, over-) profitable companies. We see a significant increase, especially in the automotive industry, which was significantly affected by COVID. In the recent past, the tax administration has succeeded in several cases before the courts to challenge the full functional and risk profile of manufacturing companies supplying independent customers, but with a significant share of decision-making centralized at the group level. Using the construction of the "hypothetical service of realizing a loss-making production for the benefit of the group", the tax authorities more or less successfully impute what they consider to be missing routine profits resulting from market or capacity risk. As has been the recent custom, they have wormed their way through the courts with some not-so-happy stories and are now trying to apply this "settled case law" to other cases. Whether or not they succeed will depend on the particular circumstances (and, of course, the quality of the reasoning and documentation).

The second area where the administration is currently rather on the defensive is the magic of so-called benchmarks (studies of comparable companies), where, on the other hand, the courts have in several cases defied the established practice and require tax administrators to provide more detailed justification as to why the interquartile range was used instead of the full range, why loss-making companies were excluded, etc. It is obvious that the tax administration will not fold its hands in this area, because if both of these objections were applied at the same time, they would no longer assess anything – in every industry there is at least one loss-making independent company… .

The second, not so obvious topic that the authorities deal with is... work-in-progress (see also our judicial window)! More and more often, tax authorities are asking about this seemingly innocent accounting method, which is designed to ensure the temporal relationship between costs and income (specifically, to postpone an expense until the period in which the income is realized), and taxpayers are taken by surprise. "Failure to account for work-in-progress" has come up in several recent cases. An engineering firm failed to prove the cost of completing major foreign projects. A construction company was in trouble over the charging of an accrual for work it had invoiced its customers for but the contractors had not completed. A case dragged on for several years where the tax administrator refused to recognize overhead costs allocated proportionately to individual projects. Another engineering firm (in an audit initiated after eight years) failed to convince the tax authorities of the correctness of the valuation of work-in-progress as it "did not provide detailed breakdowns of the materials, wages and overheads used for individual orders". Although the reasoning of the administration and the courts in many cases does not provide a clear answer as to whether these were accounting errors, a failure to carry an adequate burden of proof, or a lack of understanding by the authorities of the complexity of this complex subject, it can be concluded that accounting for work-in-progress may not be tax neutral, may lead to double taxation, and attention needs to be paid to both the maintenance and preservation of detailed records and to a factual and (to some extent to the non-specialized user) understandable explanation. Problems are also caused by the Czech specificity of looking at material and temporal continuity (with the period rather than each other) and the division of projects into sub-performances according to milestones, which may not be in line with the procedures applied in international accounting – this should improve with the upcoming amendment to the Accounting Act.

In conclusion, we can only wish all readers to avoid tax audits. And if their results have already got the interest of the analytical algorithm of the tax administration and triggered an inspection by the tax administrator, to meet with a tax administrator who will be sympathetic to the specifics of their business, so that the inspection goes smoothly and amicably, and most importantly, without any assessments!

The second, not so obvious topic that the authorities are dealing with is... work-in-progress! More and more often, tax authorities are asking about this seemingly innocent accounting method, which is designed to ensure the timing of costs and revenues (specifically, to defer an expense until the period when the revenue is realized), and taxpayers are caught off guard.

VAT

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Economic activity of members of statutory bodies from the VAT perspective

The recent tax judgment of December 2023 published by the Court of Justice of the EU ("CJEU") in Case C-288/22 has led us to consider once again what the nature of the activities of a member of a statutory body must be in the exercise of his or her functions to be considered an economic activity in terms of Act No. 235/2004 Coll. on Value Added Tax ("VAT Act").

We have long been following the approach of the Supreme Administrative Court ("SAC") in disputes concerning the economic activities of executive officers or members of boards of directors of companies. We last informed you in our Tax News here. The conclusions adopted by the CJEU in its latest judgment on the subject of the exercise of economic activity by a member of the board of directors, which we informed you about in an alert here, have prompted us to return to the topic.

As a reminder, for VAT purposes, a taxable person is a person who carries out an economic activity (an activity for the purpose of obtaining regular income) if he or she carries out this activity independently.[1]

View of the CJEU

The CJEU confirmed that there is no doubt about the economic nature of the activities of a member of the board of directors. According to the CJEU, an activity will always be an economic activity if it is of a regular nature and is carried out for the remuneration of the person who carries it out. In order to meet the regularity requirement, it is necessary that remuneration for the performance of their duties may also be granted to members of the board of directors in periods in which the company has not made a profit. At the same time, the conditions for determining remuneration must be predictable.[2]

1 § 5 of the VAT Act

2 However, in Czech circumstances, the very regularity of income generation may be questionable. Pursuant to § 61(2) of Act No. 90/2012 Coll. on business corporations and co-operatives (the "Business Corporations Act") (the "BCA"), a business corporation shall not provide remuneration pursuant to a contract of office if the performance of the office has obviously contributed to the adverse economic result of the business corporation.

The decisive factor is whether the member of the Board of Directors performs his/her activity independently, i.e. in his/her own name, on his/her own account, on his/her own responsibility and bears the economic risk associated with the performance of this activity. According to the CJEU, a board member's activity is independent if the board member bears the economic consequences of his/her decisions. However, if it is the company itself that will have to face the negative consequences of the decisions taken by the board of directors, there can be no question of the independence of a board member.

This can be illustrated by the following example. A board member of an electronic equipment manufacturing company votes in favour of a large investment in a new digital camera factory. In the meantime, however, smartphone manufacturers will incorporate the camera into their products. New digital cameras are not selling. The company is unable to pay its debts and goes bankrupt. If a member of the board of directors were liable for the company's debts and obliged to repay them out of his/her assets, the exercise of the director's functions would constitute an independent economic activity according to the CJEU. Otherwise (if it is not the board member who goes bankrupt, but the company itself) it is not an independent economic activity of the board member.

Business Corporations Act

Let's take a look at how it is with bearing economic risk in Czech circumstances. The Business Corporations Act requires members of elected bodies of business corporations to act with due care.[3] If they have not acted in good faith, they are obliged to give the corporation the benefit they have received in connection with such conduct or to compensate the corporation for the damage caused to the corporation by such conduct.[4] This principle can again be illustrated by the above example.

A Board of Directors member assesses whether to invest in a digital camera factory. He/she has carefully mapped the digital camera market and calculated the return on investment. At the time of the decision, there was no indication that smartphones would displace conventional photographic equipment. In making his/her decision, he/she acted carefully, knowledgeably, in the defensible interest of the corporation and with the requisite loyalty. In such a case, any negative consequences of that erroneous business decision will fall solely on the corporation.

In light of the conclusions of the CJEU, such a board member cannot be a taxable person.

View of the Supreme Administrative Court

In addition to the aforementioned general liability of the members of the elected body of a corporation, the SAC[5] derives business risk from the increased liability of the members of the elected bodies of corporations under the following provisions:

- According to the Business Corporations Act, the court may decide that a member or former member of the statutory body of a business corporation in bankruptcy is liable for the fulfilment of its obligations if he/she knew or could have known of the impending bankruptcy and, contrary to the care of a proper manager, failed to do everything necessary to avert it.[6]

3 § 51 of the BCA
4 § 53 (1) and (3) of the BCA
5 For example, Judgment No: 3 Afs 82/2019 - 38
6 § 68 of the BCA

- The Insolvency Act obliges debtors to file an insolvency petition without undue delay after they became aware, or with due diligence should have become aware, of their insolvency. In the case of legal persons, this obligation is incumbent on their statutory body. If this person fails to file a petition in violation of the Insolvency Act, he/she shall be liable to the creditor for any damage or other harm caused by his/her violation.[7]

- The members of the statutory body will also be jointly and severally liable to creditors if they breach their obligations under the Insolvency Act during the moratorium. They shall only be exempt from liability if they can prove that the damage or other harm could not have been prevented even if they had made all the efforts that could reasonably be required of them in the light of the moratorium.[8]

- The Insolvency Act further provides that if the insolvency petitioner is a company, the members of the statutory body shall be jointly and severally liable for compensation for damages or other injury, unless they prove that they informed the insolvency court without undue delay after the filing of the insolvency petition that the insolvency petition was not filed on reasonable grounds.[9]

- Lastly, the Insolvency Act provides for the obligation of persons to guarantee the amount of a registered claim.[10]

All of the above situations are characterized by the fact that a member of the statutory body of a corporation bears a certain economic risk if he or she has breached any of his or her duties, e.g., failed to disclose an impending bankruptcy, failed to file a timely insolvency petition, or violated legal obligations during a moratorium. Simply, if he/she did not act with due care and diligence.

With some exaggeration, it can be said that according to the SAC, only a member of an elected body of a business corporation who performs his/her function in a sloppy manner will be liable to tax. If he/she acts with due care, he/she is not exposed to the above risks.

Conclusion

One can only hope that when the Supreme Administrative Court reconsiders the question of whether the exercise of the function of a member of a statutory body is an economic activity, it will submit a preliminary question to the CJEU. Only in this way can we learn definitively how it is actually correct.

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

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7 § 98 and § 99 of Act No. 182/2006 Coll. on bankruptcy and methods of its resolution (Insolvency Act)
8 § 127 of the Insolvency Act
9 § 147(3) of the Insolvency Act
10 § 181 of the Insolvency Act

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The endless tale of the concurrence of functions continues… this time at the Constitutional Court

In mid-January, the Constitutional Court issued another ruling on the so-called true concurrence of functions. True concurrence can be defined as a situation where a member of the statutory body of a commercial company performing his/her function in the commercial law regime is also employed by the company (e.g. as CEO) and his/her agreed job description includes, among other things, the performance of the commercial management of the company.

True concurrences have been the subject of court decisions since the 1990s. The Supreme Court has repeatedly ruled that a concurrent employment contract concluded in addition to the performance of an office is invalid. It based its decisions primarily on the conclusion that business management cannot be performed as dependent work. Nor was it possible to avoid, through the employment relationship, the more stringent, corporate liability regime for erroneous business decisions. It was only after the ruling of the Constitutional Court (Case No. I. ÚS 190/15 of 13 September 2016), which challenged the existing case law of the Supreme Court and described it as insufficiently reasoned with regard to the principles of autonomy of will and freedom of contract, that the Supreme Court, in a decision of the Grand Chamber (Case No. 31 Cdo 4831/2017 of 11 April 2018), took the view that a concurrent employment ("management") contract concluded in this way is not a priori invalid, but constitutes an amendment to the contractual relationship between the company and a member of its statutory body, i.e. an amendment to the contract for the performance of functions. At the same time, the legislator has gradually eliminated (with the exception of the accident insurance scheme) the differences in social security and taxation between the performance of duties and dependent work. In doing so, it has significantly reduced the incentive for company managers to arrange genuine concurrencies.

So-called false concurrence must be distinguished from the described true concurrence. The false concurrence represents a situation where a member of the statutory body is concurrently employed by the company but performs activities that do not fall within the competence of the statutory body, i.e. does not perform the business management of the company in an employment relationship. This may be the case if the managing director of an IT company is employed as a programmer in that company.

This type of concurrence is permissible. However, the concluded employment contract of a member of the statutory body is subject to the information obligation under the conflict of interest rules of the Business Corporations Act.

Factual circumstances of the finding

The complainant has served as Chairman of the Board of Directors of X, a.s. since January 1998. At the same time, he was its CEO and in 2007 he concluded a "management" contract with the company for the performance of this activity, subject to the Labour Code. He was removed from both positions in December 2008. In January 2009 he was dismissed from his employment for redundancy.

Following this factual situation, litigation was conducted between the company and the complainant, which split into two separate branches. The first branch of the dispute was the company's claim for unjustified enrichment, which was to be represented by the extraordinary remuneration paid to the complainant for his activities as CEO under the employment "management" contract. The company considered that contract to be invalid.

In this branch, the general courts first ruled against the complainant on the invalidity of the "management" contract. However, the Constitutional Court overturned their decisions by its rulings, the first (already mentioned above), Case No. I.ÚS 190/15 of 13 September 2016, and the second, Case No. III.ÚS 669/17 of 21 August 2018.

Therefore, in the "second round" of proceedings, the General Courts concluded that the complainant had acted as chairman of the company's board of directors on the basis of a contract of service (i.e. a contract of assignment). At the same time, he had a "management" contract for the position of CEO, which was subject to the Labour Code, but with the limits set by corporate law and general civil law (i.e. it is not dependent work and there is a need to respect the balancing and protection mechanisms of corporate law, etc.). The courts assessed the "management" contract – negotiated under the Labour Code – according to its content as a contract regulating certain issues relating to the performance of the duties of a member of the board of directors, or as a special supplement to the service contract. They concluded that the effectiveness of the agreement required approval by the company's General Meeting, which did not take place. Therefore, the complainant could not be entitled to the agreed remuneration ("salary") but only to the usual remuneration. However, in light of the facts, the courts concluded that the complainant was not even entitled to such a claim, since he had breached his duty to act with due care, inter alia, by having an extraordinary part of his remuneration paid to him without meeting the criteria for its payment.

The second branch of the dispute was the complainant's claim for wage compensation for February and March 2009, i.e. during the notice period of his "management" contract. In this branch of the proceedings, the General Courts held that the complainant was not entitled to compensation since his "management" contract, which would have given rise to such compensation, had not been approved by the General Meeting and therefore had not come into effect.

Opinion of the Constitutional Court

The complainant appealed to the Constitutional Court with two constitutional complaints, the consideration of which was procedurally combined into one proceeding. The complainant alleged violation of his right to a fair trial, violation of the principle of autonomy of will and the principle of pacta sunt servanda (contracts are to be respected), as well as violation of other constitutionally guaranteed rights. In particular, he criticized the Supreme Court for its conclusion on the qualification of the employment "management" contract as an amendment to the contract of service. He argued that in doing so, the Supreme Court reached almost identical consequences as when it ruled that such an employment contract

was invalid. As the managers were unaware that they should have their employment contracts approved by the General Meeting, the contracts never took effect and the benefits provided under them were thus unjust enrichment.

In its opinion on the complaint, the Supreme Court, in our view, correctly pointed out that the rule stating that the remuneration of a member of the statutory body and his contract of service must be approved by the supreme or constituent body of the corporation, prevents arbitrary determination of the terms of service by the members of the statutory body and is mandatory. Accepting the complainant's view would, in its view, lead to "the collapse of the business schemes set up by the legislator to protect business corporations, their members and third parties". An employee is not required to exercise due care and would not be held liable for the consequences of a breach of that duty.

The Constitutional Court did not satisfy the complainant. It stressed that its previous rulings, which had led to a change in the Supreme Court's reasoning, generally "only" required the Supreme Court to properly argue and specify its conclusions on true concurrence. However, they could not be interpreted as condoning true concurrence as the concurrence of two independent legal relationships, one of which is purely employment, though its content is the business management of the company.

The Constitutional Court found that the Supreme Court's new jurisprudence treating the "management" contract as an addendum to the contract of service is constitutionally compliant. It stated that the limitation of autonomy of will in corporate law includes rules defining the basic legal nature of the relationship between a member of an elected (statutory) body and a business corporation. According to the Constitutional Court, *"a member of a statutory body has a relatively autonomous position in the performance of his or her duties, which is manifested by the fact that he or she is vested with extensive discretion. In other words, he or she is entitled (and at the same time obliged) to exercise discretion, but not to his or her own advantage. A member of the statutory body has been appointed to the position with a confidence that should not be disappointed. He or she is therefore obliged to exercise his or her office with due care (loyalty and diligence). In the event of a breach of this standard, he or she shall be liable for compensation for the damage caused, without limitation as to the amount. The Constitutional Court considers that in view of this specific position of a member of the statutory body, it is legitimate to restrict the legal relationship in which his or her management activities may be performed."*

The Constitutional Court also appropriately added that: *"Another limit to the autonomy of will is the need to protect the legitimate interests of other actors (shareholders, partners, as well as creditors). These legitimate interests also enjoy legal protection (as well as the interests of the member of the statutory body and the corporation itself), including constitutional protection. The protection of shareholders is reflected in the requirement for the approval of the contract on the service of a member of the statutory body, as well as his or her remuneration, by the supreme body of the company."*

The Constitutional Court thus concluded that the conclusion of the general courts on the ineffectiveness of the "management" contract, which was not approved by the relevant body of the company (here, the General Meeting), therefore constitutes a reasonable limitation of the autonomy of will and contractual freedom, pursuing the legitimate aim of protecting the rights of the business corporation, its members and, indirectly, third parties, including the creditors of the business corporation. The complainant himself, as Chairman of the Board of Directors, should have acted with due care in 2007 and should have been aware of the case law on the consequences of concluding a parallel "management" contract (null and void at the time) and should have had the opportunity to have the agreed remuneration approved by the General Meeting as a service contract.

The case law of the Supreme Court has been described by the Constitutional Court as a balanced compromise between the interests of members of statutory bodies (who may have the right to remuneration based on concurrent contracts) and the interests of the residual owners of the company, i.e. the shareholders (who are interested in maintaining control over the remuneration system of their company's executive). It is hoped that the problem of concurrent functions will finally be clearly and definitively resolved by this decision, where the ideas of the Constitutional Court and the Supreme Court intersect.

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

In mid-January, the Constitutional Court issued a ruling that returned to the oft-addressed problem of the so-called "true concurrence of functions". This time, the Supreme Court's long-time opponent confirmed its conclusions.

Judicial window

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Important tax audit topic worthy of your attention – work-in-progress

Loosely following on from the reflections in our editorial, we bring you an interesting judgment of the Supreme Administrative Court (SAC) concerning the justification of the reduction of income on work-in-progress.

Background

The year 2010 was addressed. The tax administrator inspected a company engaged in the construction of ship equipment.

According to the tax administrator, four long-term work-in-progress contracts completed in 2010 showed a loss, while during the tax audit it was not established what specific costs in the 611 "DEBIT" account related to the completed and invoiced contracts, detailed breakdowns of materials, wages and overhead used for each contract were not provided, and the turnover of the 121 "CREDIT" account did not equal the turnover of the 611 "DEBIT" account.

The tax administrator asked the company to produce individual documents for account 611 "DEBIT", contracts and cost breakdowns for individual contracts, invoices issued for completed contracts, costing formula, inventory of account 121 "CREDIT", etc. The tax administrator demanded to prove whether the costs reported in connection with the contracts were actually related to them and what the specific costs were.

The tax administrator stressed that its doubts arose primarily because the company did not prove which specific costs (account 611 "DEBIT") were booked and which completed and invoiced contracts they related to. According to the tax administrator, the company did not provide all the required supporting documents and therefore did not bear its burden of proof.

The company naturally defended itself, stating that the tax administrator did not treat the directly related income identically as an expense, which is contrary to § 23(4)(d) of the Income Tax Act. According to the company, the tax administrator's procedure thus leads to double taxation of the same amount.

View of the courts

Both the Regional Court and the Supreme Administrative Court sided with the tax administrator, stating that the company had failed to prove the legitimacy of the reduction in income from work-in-progress.

According to the SAC, the main reason for the contested decision is that the company failed to prove the costs charged despite the tax administrator's request. According to the Supreme Administrative Court, the argument that there was double taxation cannot be justified, since the tax administrator accepted everything that the company had documented and proved.

Therefore, according to the SAC, what is relevant to the present case is not the question of the tax deductibility of the costs, but the question of the company's burden of proof regarding the accounting for work-in-progress. If the company failed to bear the burden of proof, neither the objection that the Regional Court did not deal with § 23(4)(e) of the Income Tax Act nor the objection that there was double taxation can be justified.

What do we take away from this?

The audit of work-in-progress seems to be one of the frequent topics of recent tax audits. The audit may focus in detail on the proper and consistent application of accounting methods, the rationality of cost allocation formulas, detailed cost summaries, compliance with legal documentation, etc. Caution is therefore advisable. We will be happy to assist you in reviewing your approach or with an audit.

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

The tax administrator stressed that its doubts arose primarily because the company did not prove which specific costs were booked and which completed and invoiced contracts they related to. According to the tax administrator, the company had not provided all the required supporting documents and had therefore failed to meet its burden of proof.

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Is it possible to take advantage of the non-taxation of related income when applying thin capitalisation?

In cases where companies have tax non-deductible interest expenses and at the same time receive interest income, we often encounter discussions in practice regarding the use of § 23(4)(e) of the Income Tax Act (ITA). This allows not to tax income up to the amount of "directly related" taxnon-deductible expenses.

In the past, the tax administration has also commented on this practice. Its opinions generally emphasise the obligation of taxpayers to prove a direct link between income and expenditure. A recent decision of the Supreme Administrative Court (10 Afs 221/2022) suggests that this may not always be easy:

What was it, in simple terms?

- The company issued so called crown bonds with an interest rate of 8% p.a., which were subscribed by its shareholder.
- The shareholder subsequently assigned to the company interest-free loans in the same amount that he himself had made to related foreign borrowers.
- The receivable from the shareholder from the subscribed bonds and the obligation to pay for the assigned receivables to the shareholder were set off.
- With the foreign borrowers, the company additionally agreed on an interest rate of 8% p.a.

Assessed tax

- Therefore, during the period under review, the company had interest income and expenses of the same amount.
- Interest expense did not meet the thin capitalization test and was therefore not tax deductible.
- The company argued that the interest income is directly related to non-tax interest expense and is therefore non-taxable under § 23(4)(e) of the ITA.
- The tax administrator rejected this approach, which was subsequently confirmed by the Regional Court and the Supreme Administrative Court.

Selected arguments of the Court

- The SAC confirms that the interpretation of § 23(4)(e) of the ITA can be based on the earlier case law relating to § 24(2)(zc) of the ITA. It follows that it is relevant, first of all, whether the taxpayer would have received the income without incurring the non-deductible expense.
- Although it can be argued that the bonds issued in the present case were in fact used to finance loans abroad, the courts considered this link (i.e. through set-off) to be insufficient.
- The taxpayer's position was also weakened by the fact that the interest on the foreign borrowings was negotiated after a certain time lag.

The above case illustrates that just any link, even if at first glance it appears logical, is not sufficient for the application of § 23(4)(e) of the ITA. An inappropriate set-up may also be very difficult to remedy retrospectively. What do you take from this? The application of § 23(4)(e) of the ITA must always be carefully considered, properly implemented and appropriate documentation prepared in a timely manner – we will be happy to help you with this.

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

This case illustrates that not all links, even if it seems logical at first sight, are sufficient for the application of § 23(4)(e) of the ITA.

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The offence of tax evasion as a consequence of circumventing trade restrictions

The Constitutional Court confirmed that the artificial setting up of cross-border transactions leading to the application of an incorrect VAT regime is a criminal offence, even though it is purely commercially motivated and does not represent a tax loss for the state budget.

In its recent ruling (IV. ÚS 1779/23), the Constitutional Court rejected a constitutional complaint against a Supreme Court judgment (3 Tdo 289/2022), which dealt with the question of the criminal consequences of fictitious foreign transactions used to circumvent contractual trade restrictions.

In the present case, the Supreme Court heard an appeal by an entity (a legal entity engaged in the purchase and sale of passenger cars), its executives and the director of its fleet department against a judgment finding them guilty of the offence of tax evasion and sentencing them to fines.

Background – tax-law situation

The tax entity is a legal entity engaged in the purchase of passenger cars and their subsequent sale, inter alia to Germany. As a result of a change in the sales policy of one of the largest manufacturers, the taxpayer's car exports to Germany became subject to contractual restrictions, which significantly disrupted its business model. It therefore decided to circumvent these contractual restrictions through a chain of transactions that included the following: (i) delivery of cars to Slovakia (delivery to another Member State exempt from VAT), (ii) subsequent re-delivery by the Slovak entity to a third party in the Czech Republic (delivery to another Member State exempt from VAT) and, finally, (iii) the sale of the cars by the third entity to a fourth entity related to the entity (local supply subject to VAT), which has only just delivered the cars to Germany (supply to another Member State exempt from VAT), without being bound by any contractual restrictions on the manufacturer.

However, the tax administrator concluded that the above transactions were purely fictitious and served to disguise the actual transaction – the sale of cars to a related entity, i.e. only one local supply subject to VAT. According to the tax administrator, the taxpayer therefore did not meet the conditions for applying the VAT exemption with the right to deduct when supplying to another Member State and claimed that the failure to remit output tax resulted in tax underpayment. In addition, the tax administrator also

questioned the supplier declared by the entity. Therefore, the entity was charged output tax in some tax periods and was not entitled to input tax deductions in some tax periods.

The tax dispute eventually reached the Supreme Administrative Court, which in its judgment (2 Afs 9/2021-102) upheld the tax administrator's conclusions on the fictitious nature of the chain of transactions and the failure to meet the conditions for VAT exemption. However, on the issue of the declared supplier, the Supreme Administrative Court ruled in favour of the entity and the case was returned to the tax proceedings.

Background – criminal-law situation

However, the entire dispute had a criminal dimension. The prosecuting authorities found the taxpayer's conduct to constitute the criminal offence of tax evasion under § 240 of the Criminal Code. However, in contrast to the situation in the tax proceedings, the subject of the criminal proceedings was only the unjustified application of the exemption from output tax.

In addition to the entity, criminal proceedings were also initiated against its executives and the director of the fleet department. The entity's defence consisted, among other things, of the following arguments:

- There is no tax evasion anywhere in the chain as the whole chain is tax neutral. So, the tax could not have been avoided.
- In the present case, the principle of subsidiarity of criminal repression should be respected. The taxpayer should not be subject to criminal consequences where no damage has been caused to the State.
- The obligatory element of the crime of tax evasion – intent – was not fulfilled. The intention of the taxpayer was not to shorten the tax but to circumvent the trade restrictions. The entity consulted a tax adviser who ruled out criminal consequences, also with reference to the above-mentioned neutrality of the transactions in the chain.

The criminal proceedings eventually reached the Supreme Court. In its appeal, the taxpayer maintained the above argumentation and, in addition to that, also defined itself against the sentence imposed. In its view, the fine has a similar function to that of a penalty imposed in tax proceedings. The imposition of the fine thus infringed the principle of ne bis in idem (i.e. there was a double decision in the same case).

Assessment of the Supreme Court

At the outset, it should be outlined that the criminal courts have without exception rejected the taxpayer's view of transactions as a tax-neutral chain. They considered the question of tax evasion solely through the lens of the entity itself, comparing the tax liability paid by the entity with the amount of tax liability that would correspond to the actual nature of the transactions in question.

In this respect, the Supreme Court agreed with the courts of previous instances that the entity had engaged in fictitious transactions. According to the Supreme Court, the entity did not actually supply goods to another Member State but to a related entity in the Czech Republic. In accordance with the above, it thus unlawfully extracted a tax advantage consisting in the application of the exempted transaction scheme with the right to deduct.

As to the alleged neutrality of the chain, the Supreme Court stated that the principle of neutrality can only be applied where there is no violation of the obligations laid down by law. Neither the tax nor the right to deduct is based on a formal document but on the existence of a taxable supply. It is therefore necessary that the actual state of affairs is in accordance with the legal state of affairs. According to the Supreme Court, if the taxable supply was not carried out in the manner declared in the tax documents submitted, the principle of tax neutrality cannot be invoked. The Supreme Court further noted that criminal liability for the offence of tax evasion is not conditional on the occurrence of damage or benefit.

On the question of subsidiarity of criminal repression, the Supreme Court quoted the Court of Appeal, according to which criminal liability cannot be extinguished even in view of the fact that the tax obligation was eventually fulfilled (in this case by the entity purchasing the cars from Slovakia – note), since tax offences are so socially harmful that the State cannot neglect to punish them adequately.

The Supreme Court also addressed the issue of the entity's intent. It agreed with the court of first instance that, although the defendants' primary intention was to circumvent the manufacturer's restrictions, the entity must have been aware of the unjustified tax advantage involved when carrying out the fictitious transactions. According to the Supreme Court, it can be inferred from both objective and subjective circumstances that the defendant was aware of such a consequence.

With regard to the application of the principle of *ne bis in idem*, the Supreme Court reiterated its previous case law according to which it is permissible for proceedings in which penalties are imposed to be divided into different phases and for different penalties to be imposed successively or in parallel for offences of a criminal nature. It must be the result of a holistic system as an interconnected, interrelated whole that allows for a predictable and proportionate response to different aspects of the offence so that the individual concerned is not subjected to injustice. Furthermore, it must be established that the two proceedings are connected in such a coherent manner that they form a single coherent whole. This means that the purpose pursued and the means employed must be complementary and connected in time and that the possible consequences of the legal response to the infringement in the parallel proceedings must be proportionate and foreseeable in relation to the person concerned.

It is therefore always necessary to consider whether the sanction imposed in the proceedings which were concluded first is taken into account in the proceedings which are concluded last, so as not to place an undue burden on the individual concerned. This means that the penalty imposed in the tax proceedings and the payment of that penalty must be taken into account in the individualisation of the criminal penalty.

The Supreme Court agreed with the Court of Appeal's conclusion that there was a temporal link between the tax and criminal proceedings in the present case, since the relevant additional payment assessments (which have since become null and void as a result of the Supreme Administrative Court's annulled judgment) were issued at a time when the criminal proceedings were already under way. According to the Court of Appeal, even the ratio of the amount of the fine (CZK 800,000) to the total amount of the tax penalty imposed consecutively (CZK 1,259,819) did not constitute an unreasonable burden for the entity, especially in view of the setting of the amount of the fine, which can theoretically be imposed on a legal entity in amounts from CZK 20,000 to CZK 1,460,000,000.

The Supreme Court did not accept any of the tax entity's objections and dismissed the appeal. The entity still filed a constitutional complaint against the Supreme Court's judgment, in which it repeated some of the above arguments, but the Constitutional Court found it unjustified and confirmed the correctness of the Supreme Court's conclusions in its brief reasoning.

Conclusion

The Supreme Court's judgment shows that criminal law consequences may also result from involvement in transactions which, in the whole chain, may not have led to unpaid tax or other enrichment of the entities involved, nor is that the purpose of the transactions. In fact, criminal courts look at each of the entities involved strictly separately when assessing whether the offence of tax evasion has been committed.

It is therefore necessary to exercise caution when planning a business model and, for all transactions affecting VAT liability, to monitor whether the tax documents correspond to the actual nature of the transaction and whether the tax administrator or law enforcement authorities might consider such transactions to be fictitious. This is particularly true in the case of supply chains, which may resemble typical VAT fraud chains. The fact that there is no tax evasion at any link in the chain is irrelevant in this context.

For the sake of completeness, we add that the proceedings may have been marked by a broader context where the Supreme Administrative Court in the tax proceedings pointed out the commercial illogic of the entire chain. However, no greater detail is apparent from the file.

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

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