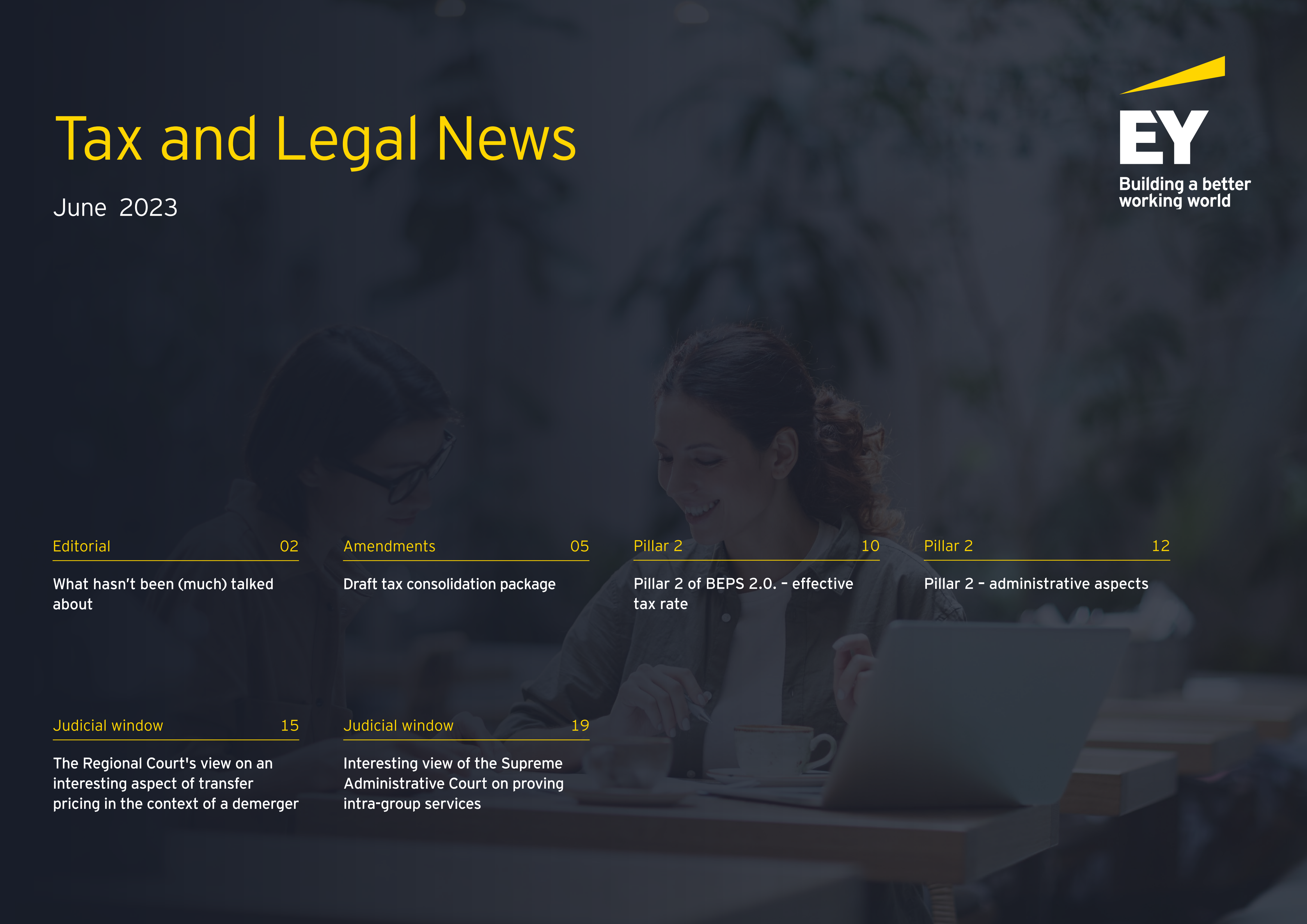

# Tax and Legal News

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Building a better working world

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# What hasn't been (much) talked about

In its proposed austerity measures, the Czech government has introduced, among other things, a tax package offering a nice brief summary of changes planned as of January 2024. Dozens of discussions on a few selected topics were held in the media, and experts assessed the impacts. A draft of a revised version of the tax package has been subject to ashort external comment procedure. And on first reading, it's clear there are many more proposed changes and even more related issues.

Let's take a look at selected (previously undiscussed) tax developments, and let's just say the tax package has more than a few potentially problematic areas.

The first unexpected surprise is the abolition of the exemption for exchange gains on the exchange of money in an account. A seemingly small thing can easily turn into both a nightmare and a nice exercise in providing evidence. The exchange gain on such an exchange of money will continue to be exempt only if, together with all other "unclassified" other income, it falls within the annual limit of CZK 50,000. So if you have a euro account, you buy euros now at the current favourable exchange rate of, say, 20,000 euros for 23.50 CZK/EUR, and in a few years, when the euro/crown exchange rate rises again, say to 27 CZK/EUR, you will need to exchange it back into crowns and will realise an exchange rate gain of CZK 70,000. You will have to recognise this exchange gain in your tax return. However, you will also have to tax a much lower exchange rate gain if, in addition to the exchange rate gain, you also have income from occasional activities and in total this income exceeds CZK 50,000 for the tax year.

The second change will limit the amount of exempt income from the sale of securities or shares after three or five years from the acquisition to CZK 40 million per tax year. As the saying goes, the devil is in the details. In this case, the transitional provisions or rather the lack thereof. The very broad exemption for income from the sale of securities was already changed in the past in the form of an extension of the time test from 6 months to 3 years. At that time, however, the transitional provisions made it clear that the time test for securities acquired before the effective date of the amendment would be assessed under the old provisions. However, the proposed amendment does not contain anything similar, i.e. from January 2024 the limit will apply to all income from the sale of securities and shares, regardless of when they were acquired. It should be added, though, that the draft text of the amendment allows for income from the sale of securities or shares acquired before 31 December 2023 that exceeds the exempt CZK 40 million to deduct as a cost either their actual acquisition price or the market value determined in accordance with the law governing the valuation of property at 31 December 2023.

Next up are bottles of still wine. Newspaper articles have been flooded with reflections on the excise duty on still wine and the (in)correctness of its (non-) introduction. However, the revised version of the Income Tax Act amendment contains a completely different "bombshell" – it abolishes the deductibility of the costs of a gift of still wine up to the value of CZK 500. While the impact on the state budget revenue is debatable, the impact on winemakers' pre-Christmas sales may be noticeable.

The fourth rather convoluted change concerns meals for consumption in the workplace. The government's intention is clear – to set the same rules for meal vouchers/meals and meal allowances. However, the draft wording generally limits the exempt value of meals for consumption in the workplace. Thus, if an employee receives a free sandwich and doughnut in addition to the maximum exempt meal allowance at a meeting, tax and insurance premiums should technically be paid on the value of those two meals. I'm looking forward to seeing how employers prove who ate what.

The government's efforts to increase tax revenues are commendable. The question is whether, in the current situation, it would not be better to focus on a few well-thought-out changes that will have a big impact on budget revenues instead of trying to suddenly solve all the non-conceptual exemptions and exemptions that have accumulated in the tax code over the years.

**An unexpected surprise is the proposed abolition of the exemption for exchange gains on the exchange of money in an account. A seemingly small thing can easily turn into a nightmare and a nice exercise in providing evidence.**

# Amendments




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# Draft tax consolidation package

Several weeks ago, the government presented a set of intended measures to help consolidate public finances. Subsequently, the paragraph-by-paragraph text of the proposed amendments has been published. Below we briefly present a selection of the proposed changes in tax and related areas (more details HERE).

**Corporate income tax[1]**

- *Tax rate* - Increase the corporate income tax rate to 21% (from the current 19%).
- *Meal allowances* - For employers, expenses for meal allowances should be tax deductible under the current Section 24(2)(j)(5) of the Income Tax Act (ITA), i.e. expenses incurred to fulfil employees' rights relating to their working and social conditions (including meals) arising from a collective agreement, an employer's internal regulation or a contract concluded with the employee should generally be deductible.
- *Non-monetary benefits from employers to employees* - Following the abolition of the exemption for non-monetary benefits provided by employers to employees (see the personal income tax section below), the provision according to which the employer's expenditure on such non-monetary benefits was a non-tax deductible expense is deleted. The deductibility of these expenses should now be assessed under the current Section 24(2)(j)(5) of the ITA. Similarly, the limitation on facilities for meeting employees' needs is deleted.
- *Extraordinary depreciation for electric vehicles* - The possibility to claim extraordinary tax depreciation is extended - only for motorised road vehicles using only electricity as fuel acquired between 1 January 2024 and 31 December 2028. The taxpayer can depreciate this vehicle over 24 months, up to 60% of the entry price for the first 12 months and the remainder for the following 12 months.
- *Depreciation limit for vehicles* - For M1 vehicles (put into a condition suitable for normal use as of 1 January 2024), a limit of the input price (or a limit of the amount of the rental fee when acquired by means of financial lease) of CZK 2,000,000 is introduced. The exception applies to ambulances and hearses, vehicles used for the operation of road motor transport on the basis of a concession and vehicles provided by taxpayers as the subject of a finance lease.

1 Generally for tax periods beginning on or after 1 January 2024.

- *Silent wine* - Elimination of tax deductibility of silent wine as a representation expense up to CZK 500.

- *Notification of income to non-residents* - The taxpayer's notification obligation will now not apply to income to a non-resident taxpayer that would be subject to withholding tax but is exempt from tax or not subject to taxation in the Czech Republic under an international double taxation treaty - but with the exception of dividends and royalties (at the same time, the simplifying materiality limit for exemption from the notification obligation is abolished).

- *Ukraine/donations* - Income tax measures for the purpose of supporting charitable activities - in particular aimed at assisting Ukraine and its population (pursuant to Act No. 128/2022 Coll.) are generally extended for 2023 under the existing conditions.

## Personal income tax

- *Reduction of the threshold for application of the higher tax rate* - The threshold for application of the tax rate of 23% is reduced. A taxpayer's tax base exceeding 36 times the average wage will now be subject to the higher tax rate (compared to 48 times today). Similarly, the monthly threshold for applying the higher tax rate will be reduced from four times the average wage to three times the average wage.

- *Limitation of exemption on sale of securities/shares* - A maximum amount of CZK 40 million per taxpayer per taxable year is introduced for the exemption of the transfer of securities or business shares for consideration if the time test (3 or 5 years) is met. For non-exempt sales of securities and shares in excess of CZK 40 million acquired before the end of 2023, the taxpayer will be able to optionally claim as an expense the market value of the security/share as at 31 December 2023.

- *Non-cash benefits* - The exemption for non-cash benefits provided in the areas of culture, education, purchase of medical services, recreation and tours is fully abolished. In addition, the exemption for non-monetary gifts up to CZK 2,000 provided under the terms of the FKSP is abolished.

- *Meal allowances* - The conditions of exemption for the provision of meal allowances to employees are unified. The current exemption applicable to the so-called meal voucher lump sum will also apply to meals provided in a non-monetary form (meal vouchers, company meals). At the same time, however, it will be possible to take into account the duration of a shift longer than 11 hours for the meal allowance.

- *Spouse's credit* - The conditions for applying the spouse's credit will become stricter; in addition to the condition of the spouse's income not exceeding CZK 68,000 for the tax period, there will be a condition that the spouse must live in a jointly managed household with the taxpayer's child who has not reached the age of 3.

- *Other credits* - The student credit and the credit for the placement of a child are abolished.

## Insurance

- *Sickness insurance* - The amendment introduces sickness insurance for employees. The social security contribution for employees will therefore now be 7.1%, of which 6.5% is pension insurance and 0.6% is sickness insurance.

- *Work performance agreements (WPAs)* - The rules for exemption from paying insurance premiums for WPAs (currently all WPAs up to CZK 10,000) are tightened. The limit varies depending on whether the employee has a WPA with one or more employers at the same time.

In addition, a notification obligation is introduced for an employee working on the basis of a PPA with several employers in one calendar month, in particular for the purpose of monitoring the limits of the relevant income for the contribution. Failure to comply with this obligation may result in the employee himself being obliged to pay insurance premiums for both himself and his employer (a relatively unique instrument in the Czech environment).

- *Assessment base of self-employed persons* - The minimum assessment base for self-employed persons for pension insurance premiums is increased from the current 50% of the partial tax base on income from self-employment before 2024 to 55% from 2024.

- *Minimum advance payments for self-employed persons* - The minimum monthly assessment base for self-employed persons is gradually increased, with 25% of the average wage for 2023, increasing by 5% each year thereafter to a final 40% of the average wage from 2026.

## VAT[2]

- *Rates* - There will be two VAT rates - the basic (21%) and the reduced (12%). In connection with this, the annexes to the VAT Act will be amended.

- *Beverages* - There is a significant change in the taxation of beverages. It will only be possible to serve tap water at a reduced rate as part of a catering service. The supply of other beverages will be included in the standard rate of VAT. For the supply of foodstuffs it will be possible to include tap water and certain liquid dairy products in the reduced rate of VAT. Other alcoholic and non-alcoholic beverages will be at the standard rate of VAT. Confusion may arise regarding the classification of certain items (e.g. loose tea, coffee beans) as beverages or foodstuffs.

- *Transport* - Non-scheduled public land transport of passengers (e.g. regular transport of employees of a company, transport of pupils to the theatre, but not taxis) is moved from the standard to the reduced VAT rate.

- *Books* - Books that meet the definition of the law will be exempt from VAT with the right to deduct tax, both in physical media (paper, CD, DVD) and in electronic form, including audiobooks. Taxpayers will be able to request a binding ruling from the tax administration when claiming VAT exemption on books.

- *Newspapers and magazines* - Periodicals (newspapers and magazines) published no more than three times a week will be at reduced rate. In case of higher periodicity, the standard VAT rate will be applied.

- *Other* - Services such as municipal waste collection, transport, disposal and treatment, services of authors and performers and other services included in the reduced rate in connection with the introduction of the EET and the Covid-19 pandemic (e.g. cleaning and hairdressing services, shoe and clothing repairs) will be moved to the standard VAT rate. Imports of works of art, collectibles and antiques, supplies of firewood and supplies of cut flowers and decorative foliage will also be moved to the standard rate of VAT.

## Excise duty

- Excise duty on alcohol and on cigarettes, smoking tobacco, cigars and cigarillos is increased by 10% for 2024 and 5% each year from 2025 to 2027.

2 Changes will generally be effective as of 1 January 2024.

- The excise duty on heated tobacco will increase by 15% each year for the next 4 years.
- A new excise duty is introduced on other tobacco products (chewing and snuff) and on tobacco-related products (e.g. nicotine sachets, e-cigarette refills, nicotine-containing products).
- The tax rate on shisha tobacco will decrease slightly.
- The amount of security for tax on alcohol for tax warehouse operators is increased.
- The exemption for aviation fuel for any domestic transport (including air ambulance services) is abolished.
- The procedure for refunding excise duty on green diesel is simplified.
- The refund for mineral oils used for metallurgical or mineralogical processes is abolished. However, it will be possible to claim an exemption for some mineral oils or to claim a refund of part of the excise duty when used for heat production.

### Energy taxes

- The exemption from tax on electricity, gas and solid fuels when used for metallurgical or mineralogical processes is abolished.

### Gambling tax

- Compared to the current rules, only two rates of gambling tax are now provided for. For all types of lotteries and technical games, the current individual sub-tax rate of 35 % is maintained. For other games of chance, the tax rate is increased from 23 % to 30 %.

### Real estate tax

- There is an increase in the form of a new state part of the real estate tax (generally equivalent to the tax rate without the application of a local coefficient). An automatic indexation to take account of inflation is also introduced.

Regarding the timing of the legislative process, it can be expected that the government's ambition will be to carry out the first reading of this initiative in the Chamber of Deputies before the summer holidays. We will continue to monitor the development of this initiative for you.

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

**Among other things - a maximum amount of CZK 40 million per taxpayer per taxable year is introduced for the exemption of the transfer of securities or business shares for consideration if the time test (3 or 5 years) is met. For non-exempt sales of securities and shares in excess of CZK 40 million acquired before the end of 2023, the taxpayer will be able to optionally claim as an expense the market value of the security/share as at 31 December 2023.**

# Pillar 2

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# Pillar 2 of BEPS 2.0. – effective tax rate

In this part of the series on the BEPS 2.0 - Pillar 2 initiative, we will look at the calculation of the effective tax rate. One would expect this to be obvious, as you divide the tax by the profit and you're done - not quite, let's take a closer look at the calculation.

In previous articles, we've covered what adjusted covered taxes are and what qualifying income (profit or loss under the GloBE rules) is. We also defined what is considered a constituent entity, or where a permanent establishment or tax transparent entity falls.

The effective tax rate is determined at the jurisdiction level. In other words, the qualifying income of all constituent entities in a jurisdiction (with certain exceptions, such as investment entities as defined in the Pillar 2 rules) are added together and their adjusted covered taxes are added together as well. The ratio of the sum of the taxes and the positive sum of the qualifying income will give us the effective tax rate for the jurisdiction. This calculated rate is compared to the minimum 15% tax rate.

If the calculated rate is less than 15% (we then speak of a top-up tax percentage), an excess profit is calculated, from which the top-up tax for the jurisdiction is then determined. The excess profit is the total qualifying income for the jurisdiction net of the so-called substance-based income exclusion. This exclusion is determined as 5% of the qualifying payroll costs and 5% of the value of the qualifying tangible assets (this is simply the net book value of, particularly land, buildings and equipment, unless held for sale, lease or investment). For a transitional period until 2032, the percentages are higher.[3]

The top-up tax is then calculated as the product of the positive amount of the adjusted excess profit and the top-up tax percentage.

Based on the draft local implementations of Pillar 2 available so far, it appears that the states will apply the domestic top-up tax in large numbers, and that the calculation of the domestic top-up tax will be the same (or very similar) to the calculation of the top-up tax presented above. It can then be assumed that individual states will levy a domestic top=up tax and that the top-up tax will not subsequently be levied at the level of the ultimate parent entity.

Mathematically, the calculation of the effective rate and the top-up tax does not look complicated - take two numbers, subtract or divide them and that's

3 For payroll costs, the percentage gradually decreases from 10% for 2023 to 5.8% for 2032 and for tangible assets from 8% for 2023 to 5.4% for 2032. From 2033 onwards, 5% will apply.

it. The problem is where to get the numbers and what is behind the various definitions, e.g. what exactly is the net book value of qualifying tangible assets, how to determine the qualifying payroll costs for employees working at home country and abroad. At EY we have a detailed guidance and a process to help you remember and prepare for the fact that this information and data will need to be prepared for the 2024 return and as in any other tax procedure, the burden of proof is on the taxpayer.

You can look forward to the continuation of our series on Pillar 2.

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

**At EY we have a detailed guidance and a process to help you remember and prepare for the fact that this information and data will need to be prepared for the 2024 return and as in any other tax procedure, the burden of proof is on the taxpayer.**

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# Pillar 2 – administrative aspects

Recently, the draft Czech implementation of Pillar 2 rules was published, i.e. the draft law on top-up taxes for the purpose of ensuring a minimum level of taxation of large multinational and national groups.

Below are selected observations on the related administrative aspects.

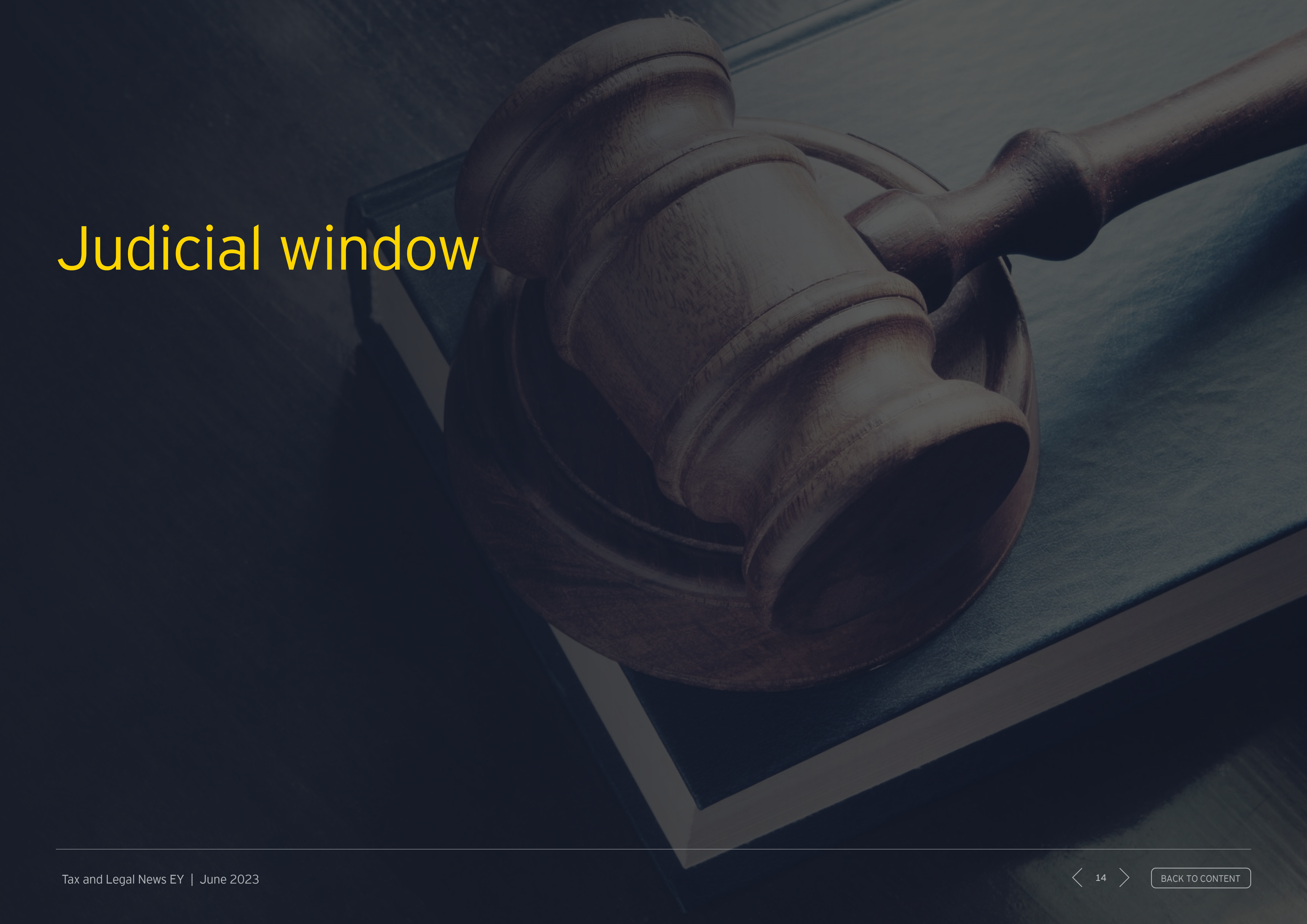
- The taxpayer of the top-up tax (TT) - both domestic top-up tax and top-up tax based on Income Inclusion Rule (IIR TT) - is a Czech constituent entity and a foreign constituent entity with a Czech permanent establishment.
- The Specialised Tax Office is the administrator of the TT.
- A TT taxpayer with a seat outside the EU/EEA is obliged to choose a representative agent that has a registered office in an EU Member State.
- There will be an exclusively electronic form of filing (via the tax portal).
- The application for registration for TT will have to be submitted within 15 days from the date on which the entity became a TT taxpayer (the MoF has already indicated that this deadline is likely to be extended).
- Domestic TT returns will be filed within 10 months, while IIR TT returns will be filed within 22 months (deadlines cannot be extended).
- The information package for the domestic TT will be filed within the deadline for the domestic TT return (i.e. 10 months) - the deadline cannot be extended.
- The information package for IIR TT will be submitted within 15 months (18 months for the first period) - again the deadline cannot be extended. This package may be filed by the ultimate parent (or designated) entity in the qualifying state if the content is identical and filed within the same deadline (but this will need to be notified).
- The details of the information package will be set out in the implementing regulations.
- The self-assessment regime will apply.
- The statute of limitations is different from the general one - generally 4 periods after the due date (the statute of limitations does not run during the related court proceedings).
- A supplemental information return for a lower TT cannot be filed in the last year of the statute of limitations.

- Non-monetary penalty will be applied up to CZK 1.5 million.

It may seem that there is enough time to prepare. After all, the first return will not be filed until October 2025. Nevertheless, we recommend making an initial assessment of the rules' outcome now and thinking through, for example, the operation of various elections, the effect of the transitional provisions themselves, the regime of material items that may affect the effective tax rate, etc. We then recommend implementing a process to calculate the top-up tax and think about e.g. where to get the data, how to verify the collected data, how to calculate the effective tax rate, etc. In many cases, it may be that the first figures will need to be included in the first quarter 2024 financial statements (i.e. April 2024).

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

**Domestic TT return will be filed within 10 months, while IIR TT return will be filed within 22 months.**



# Judicial window

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# The Regional Court's view on an interesting aspect of transfer pricing in the context of a demerger

In this issue, we present a very interesting Regional Court judgment in the area of transfer pricing in the context of corporate transformations.

### What was it about?

- At the heart of the dispute was the issue of whether or not to include amortisation of a valuation difference in the cost base for calculating profitability using the transactional net margin method (TNMM) and the net cost plus margin (NCPM) indicator.
- According to the tax administrator, due to the exclusion of the amortisation of the valuation difference from the cost base, the overall profitability of the given company did not reach the bottom quartile based on the performed comparative analysis.

### The situation in more detail

- The company in question was formed as part of a demerger with the creation of a new company.
- In accordance with the Transformation Act, the valuation of the spun-off part was performed (using the discounted cash flow method and the capitalized net income method for the valuation of non-operating assets). In this context, a valuation difference was recognised in the company's opening balance sheet, which was amortised to expense over 15 years in accordance with Czech accounting regulations, whereas under accounting in accordance with international (or US) accounting standards, this valuation difference was not amortised and did not affect profit or loss on an ongoing basis.
- The main economic activity of the company was the production and subsequent sale of welding materials. The Czech company was engaged only in production activity, while a foreign group company specialized in the development of new products (design, functionality, technical parameters, material, etc.) and their subsequent placement on the market.

- There was no dispute between the company and the tax administrator that the Czech company was a so-called contract manufacturer.
- The company produced for a foreign group company under a production contract which set the company's target profit margin for 2014 and 2015 at between 2.5% and 3.5%, and adjusted to 3% if the actual profit margin achieved were to be outside this range. These values were determined on the basis of a comparative analysis showing a minimum profit margin of 0.41% and an interquartile range of profit margins between 2.14% and 5.17%.
- Neither the tax administrator nor the company disputed the conclusions of the comparative analysis. The company regularly reviewed whether its profitability was within the above range based on agreed processes. If this was not the case, an adjustment was made to the invoicing to the foreign company to the value of 3%.
- The main point of contention between the company and the tax administrator was the issue of including the amortisation of the valuation difference in the cost base.

**Selected arguments of the company**

- The inclusion of the amortisation of the valuation difference in the cost base goes against the economic substance of the valuation difference arising on the transformation of companies, which is not an actual cost of the taxpayer but a reflection of the future expected profit potential of the spun-off part of the plant.
- The inclusion of the amortization of the valuation difference in the cost base violates the comparability of entities providing the same production services solely on the basis of their corporate history, which is contrary to the tax neutrality of transformations.
- The amortisation of the valuation difference does not, by its nature, represent an actual cost incurred for the transaction under consideration (the provision of a production service). It is an extraordinary item caused by the transformation which should be excluded from the cost base in accordance with item 2.86 of the OECD Guidelines. The exclusion of the amortisation of the valuation difference from the cost base is also supported by paragraph 2.90 of the OECD Guidelines, which states that careful consideration should be given to the inclusion of items whose accounting treatment may not be comparable for the entities included in the comparative analysis.
- The tax administrator's argument that the company acquired the property at fair value, which it would have had to pay in full in the event of a purchase, is completely wrong – the expert valuation of the so-called spin-off does not take into account the value of the individual components of the property, but the value of the spin-off as a whole (i.e. the value of the plant and its future profit potential).
- The tax administrator's procedure is contrary to the principle of tax neutrality of transformations resulting from the Income Tax Act (ITA), since exclusively as a result of the implemented transformation, this logic leads to an increase in the cost base, which would not have otherwise occurred (without the implementation of the transformation leading to a valuation difference).
- In addition to the incorrect procedure used when including the valuation difference amortisation, the company further claims the tax administrator committed an unlawful procedure in applying the margin resulting from the performed comparative analysis. The unlawful procedure consists in applying the profit margin at the level of the bottom quartile rather than at the level of the minimum resulting from the comparative analysis. The minimum according to the comparative analysis is 0.41%. The profitability of the company as calculated by the tax authorities after including the amortisation of the valuation difference in the cost base was 1.52% and 1.33%, respectively,

and therefore exceeds the minimum found in both years. If the tax administrator had correctly applied the profit margin, it would have concluded that the company's profitability was within the market range and that there was therefore no basis for charging tax.

- With regard to the tax administrator's argument that the use of the interquartile range serves to eliminate outliers, the company stated that in the present case there is certainly no extreme between the minimum observed market value and the lower interquartile range, since the minimum value is 0.41%, while the lower interquartile range is 2.14%, the median is 3.88% and the upper interquartile range is 5.17%. In this respect, the sample of comparable data is within a narrow price range without significant outliers, so the application of statistical methods is not justified, according to the company.

- Should the value of the valuation difference amortisation enter the cost base, the company's request to exclude the corresponding income from the tax base due to its direct connection with non-tax-deductible expenses is justified, as the accounting amortisation of the valuation difference is a non-tax-deductible expense, which would fulfil the tax neutrality of the chosen form of corporate restructuring.

### View of the Regional Court

- The Regional Court sided with the tax administrator on all the main elements of the dispute.

- The Court held that the tax administrator had correctly concluded that the cost item in relation to the valuation difference was related to the company's contract manufacturing and that there was therefore no objective reason for excluding it from the cost base when calculating the profitability ratio. The company did not incur any real expenditure either on the valuation difference or on the asset as such. It merely took over the assets from its predecessor and included the depreciation of the remaining assets in the calculation of its profitability, thus acquiring assets for which it would have had to pay the purchase price if it had bought them. There is no doubt that these assets generate income for the company and, if sold, their residual value would be a cost and the sale itself would generate income. Therefore, the argument that the amortisation of the valuation difference is not an actual cost incurred for the transaction under assessment and is an exceptional item caused by the realised transformation cannot be accepted.

- The Court also disagreed with the company's claim to exclude the corresponding income from the tax base because of its direct connection to non-tax-deductible expenses, since the accounting amortization of the valuation difference is a non-tax-deductible expense. The Court held that the tax authorities reasonably assumed the company did not receive any income (revenue) in connection with the inclusion of the valuation allowance in the cost base. The adjustment of the cost base by the valuation difference was thus only an adjustment of the tax base for tax purposes and is not reflected in the company's income. Thus, in the company's case, no direct link can be inferred between the non-tax-deductible costs claimed and any income arising from the calculation of the profit surcharge, or a direct "re-invoicing" of those costs. The Court further stated that the calculation of the profit margin alone, where non-tax-deductible costs entered into the calculation of the transfer price, does not automatically lead to the conclusion that any amount on the cost side demonstrably generates an identical return to the company and thus that the conditions for the application of § 24(2)(zc) of the ITA or § 23(4)(e) of the ITA are met.

- The Court also disagreed with the objection that the tax administrator had acted unlawfully by applying the profit margin at the level of the bottom quartile, rather than at the level of the minimum resulting from the comparative analysis. In this context, the Court stated that, although it is generally the case that the aim is to apply the most favourable procedure for taxpayers in tax proceedings, in the present case the tax administrator did not act contrary to this principle when, in order to eliminate outliers and inaccuracies and to establish the maximum possible comparability, it applied statistical methods which take into account the mean trend.

A cassation complaint has been filed, so let's see what the Supreme Administrative Court has to say about this.

Finally, a note on a related aspect that caught our attention. The judgment holds that the valuation difference in question is not amortised for the purposes of international or US accounting rules. The question is therefore whether the tax administrator's conclusion would have been different had the contractual documentation specifically referred to these (non-U.S.) accounting data. Our practical experience suggests there are situations where the tax administrator accepts IFRS data as the basis for setting transfer pricing. Our takeaway from this story is that no detail is worth underestimating.

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

**The Court held that the tax administrator had correctly concluded the cost item in connection with the amortisation of the valuation difference was related to the company's contract manufacturing and that there was therefore no objective reason for excluding it from the cost base when calculating the profitability ratio. The Court also disagreed with the argument that the tax authority had acted unlawfully in applying the profit margin at the lower quartile level rather than at the minimum level resulting from the benchmarking analysis.**

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# Interesting view of the Supreme Administrative Court on proving intra-group services

In this issue, we present an interesting Supreme Administrative Court (SAC) judgment concerning the issue of proving costs for consultancy services.

**Background**

- The tax administrator carried out a tax audit of a company for corporate income tax for the year 2011 and disallowed costs in the following areas:
  - consultancy services for production from a related foreign company;
  - IT and HR support services, CEO management services, legal advice, financial management, sales, marketing and related administration from a related foreign company;
  - services relating to the refinancing of the company's obligations from a related foreign company.
- According to the tax administrator, the company did not prove who specifically provided what services, where, in what period and to what extent. The company was also unsuccessful in its related action before the Regional Court. In particular, the tax administrator had doubts in the following areas:
  - The company did not prove the consultancy services were linked to the claimed savings or that the quantified savings were linked to its accounts and to the individual cases of services provided - according to the tax administrator, the evidence shows that production increased between 2010 and 2013, but not that this was due to the services in question.

- The company failed to provide a detailed description of the monthly fees for each invoice, though the provider was contractually obliged to provide such a breakdown.
- It is not possible to verify from the proposed evidence (meeting minutes, email correspondence and related documents, studies and implementation documents) what specific services were provided, who provided them, where and for how long, and with what result.
- A witness, the group's chief operating officer, made decisions about what and where to produce at the group level for the benefit of the company's owner, not on the basis of specific company requirements, and his answers were general and did not say anything specific about the implementation of the services; his testimony did not show that the savings were achieved solely through the activities of the consulting company.
- Another witness did not confirm that she dealt with specific requests from the company, but only that she worked for the benefit of the owner of the company; the value planning services she provided covered all the companies in the group and served the owner's decision-making needs; at the same time, it is not clear how, with whom, where and for how long she carried out the alleged activities, and the fact that the team the witness allegedly led included employees of the company also raises doubts.

- The company's main objections were as follows.
    - The company considers that, for each group of disallowed costs, it has identified documentary evidence and witness statements which, in its view, demonstrate that the services were actually provided to the extent claimed.
    - The company never claimed it had achieved the savings only through consulting activities, and it refuted the tax administrator's doubts by calculating the savings.
    - The tax administrator illegally rejected certain evidence because the time necessary to produce it was not apparent.
    - The consulting firms provided detailed summaries of services provided in connection with the refinancing invoices, and testimony confirmed the services provided.
    - Support services were invoiced on the basis of the wage costs of individual employees and the costs were allocated indirectly between the various production sites in the group (30% was allocated to the company). In addition to the testimonies, the provision of support services is confirmed, in particular, by e-mails.
    - Taking into account the manner in which the fees for the selected services were determined (a percentage of the actual cost savings achieved), and the amount and detail of the documentation provided, the company cannot rationally imagine what further evidence it would have to provide to the tax authorities.

### View of the Court

The Supreme Administrative Court upheld the company's objections concerning the first group of disputed services, i.e. consultancy services for production, while for the other two groups of services it sided with the tax administrator's assessment – below we present selected arguments.

### Consultancy services for production

- The reasoning of the tax administrator and the Regional Court regarding the consultancy services for production is mainly based on the fact that the company did not prove the declared services were linked to savings, i.e. that the savings were achieved exclusively through the activities of the company providing the consultancy in question. However, according to the SAC, this reasoning is incorrect.

- From the outset, the company explained that setting a fee for any consulting services with an uncertain outcome (typically productivity improvement, process consulting, savings seeking) was problematic because it was not routine activity. A consultant can spend a lot of time without results, and conversely just one idea can lead to significant savings. Therefore, the company has linked the fee to precise criteria: the result and the savings (and thus efficiency) achieved in three areas [more efficient use of materials (value planning), reduction of overheads and reduction of direct costs]. However, it did not claim that the savings were achieved through consultancy work alone. It explains that this is why the fee is a 20 per cent share of the calculated savings, not more. This explanation is logical, rational and persuasive; by contrast, it is unreasonable to require the company to specifically identify each individual "production advice" and to precisely quantify its economic contribution, from which the fee should be calculated.

- Costs must be directly attributable to the business activity, reasonable and directly related to the expected revenue. There is not necessarily a directly proportional relationship between expenditure and income, but it must be expenditure incurred for that purpose. However, the decisions of both the tax administrator and the Regional Court are based on the opposite conclusion and therefore, according to the SAC, cannot stand.

- Nor can the documents (e.g. various analyses) be dismissed out of hand on the assumption that they were probably used for a decision made by the company owner (whether to move production from Italy) and not by the company. According to the court, who was most served by the documents is not decisive; in other words, for the assessment of the tax deductibility of costs, it is not essential from whose head a certain business decision originated (whether from the controlling company or the managing director of the controlled company) and whether the activity also served the needs of the owner, but whether the tax entity proved that the costs were incurred in connection with generating taxable income. Logically, the income of the controlled company can then bring more income to the controlling company. Nor would it make any difference if the controlling entity – to put it simply – by virtue of its position of power made the controlled entity use certain services and pay for them. For the assessment of tax deductibility, it is a question of the company proving the receipt of the services and their purpose: the expected profit. The company must therefore prove that the services benefit (also) it, and the tax administrator must challenge this, rather than being satisfied that the services are more likely to benefit the owner of the company or the group as a whole, or requiring that the services be performed solely for the benefit of the company.

- The SAC, unlike the Regional Court, does not consider the summary treatment of the documentary evidence to be sufficient (as the tax administrator did). In general, it is not precluded for the administrative authority to comment on numerous pieces of evidence collectively, but this depends on the specific circumstances of the case. In this case, though the company submitted a considerable amount of documentary evidence in the tax proceedings (minutes of meetings, e-mail correspondence, studies, analyses, etc.), it accurately identified and assigned them to specific groups of disallowed services. Although the tax administrator commented specifically on some of them at various points in the decision, it stated regarding the rest of them that "the benefit of many of them was not ascertainable, nor was the time required to prepare them, or by whom they were prepared", and further reiterated that the link between the consultancy services and the claimed savings had not been established. The argument that the time required to generate some of the documents was not ascertainable is irrelevant, especially since the agreed fee for services was not linked to it. The remark that the benefit of many of the submissions was not ascertainable lacks specificity.

- The Court also shares the reservations regarding the tax administrator's and the Regional Court's assessment of the witness statements. It is true that the statements are rather general, but at the same time they are consistent with each other and with the company's arguments. The witness statements must also be assessed in combination with the other supporting documents, in particular the documentary evidence, which contains some greater specifics and outcomes. When the tax administrator states, for example, that the witness did not detail how she managed the process and the activities she was in charge of, with whom, where and for how long, the Court notes that the witness answered all the questions asked and the tax administrator did not even ask her for more details. The same applies to the statements of the other witnesses. The Court does not dispute that the burden of proof is on the taxpayer and that it is therefore up to the taxpayer to prove the facts alleged and to bear the consequence of disallowed costs if it fails to do so, but the tax authorities should also take care to ensure that the facts relevant to the correct determination and assessment of the tax are established as fully as possible. In a particular case, this may also mean that they should be able to ask the right questions and make further enquiries.

- Furthermore, according to the Court, the mere fact that some of the meetings were attended by employees of the company does not raise doubts as to who actually carried out the activities; on the contrary, it corresponds to the manner in which the services were provided, as described by the company and the witnesses.

### Refinancing services

- The company explained that the services related to the requisite need for new financing on acceptable terms were provided centrally to the entire group by external consultants and the cost was then shared among the various group companies that drew down loans according to the volume of funds drawn down. The foreign company therefore re-invoiced the company for a proportionate share of the services provided.

- Although neither the tax administrator nor the Regional Court disputes that the loan was refinanced and that this step was necessary, this is not sufficient to sustain the burden of proof. The Court considered the most significant deficiency to be that the company did not credibly prove (by means of loan agreements or otherwise) the terms and conditions of the loan and, in particular, the extent to which the individual companies of the group had drawn on it. It has therefore failed to demonstrate that the costs were actually apportioned between the companies as claimed and that the amount of costs claimed is consistent with its claims.

- Furthermore, the company has not even demonstrated the specific scope and content of the services. In the documentary evidence and in the witness statements, the services were defined in such general terms that it is impossible to determine whether they actually related to the refinancing of the loan.

### Support services

- The tax administrator reproached the company, among other things, for invoicing amounts during the year without a direct link to the services provided, and for failing to document the allocation key for the distribution of costs between the individual companies. In addition, the company did not document the specific outputs of the consultancy activities and the specific content and scope of the services; the witnesses only confirmed the different areas of cooperation in general terms, which is not sufficient for the expenditure of millions of euros for services.

- The Court generally agreed with the tax administrator's assessment. According to the Court, the company had not clearly demonstrated how the fees for services rendered were determined. Although the witness statements confirm in very general terms that the company received some support services from its parent company, this is not sufficient for the costs to be recognised. The company has not proved the specific content and scope of the services, either by documents or otherwise; for amounts spent in the tens of millions of crowns, it is not unreasonable to require it to provide more detail on the services than it has provided.

The above demonstrates that the SAC has gone to great trouble to carefully assess the various areas and the evidence presented. This can serve as inspiration and guidance for the preparation of submissions in the context of intra-group advisory (and other) services. We have extensive experience in this area and would be happy to assist you in this matter.

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

**According to the Court, the documents (e.g. various analyses) cannot be disregarded across the board on the assumption that they were probably used for decisions made by the company owner, not by the company. Whom the documents served most is not decisive, according to the Court; in other words, it is not essential for the assessment of the tax deductibility of the costs to know from whose head a certain business decision originated (whether from the controlling company or the managing director of the controlled company) and whether the activity also served the needs of the owner, but whether the taxpayer has proved that the expenses were incurred in connection with the acquisition of taxable income.**

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## Did you know:

- The General Financial Directorate has provided answers to further selected questions concerning the application of the windfall profits tax?
- A draft amendment of the Investment Companies and Investment Funds Act has been published?
- A new Double Tax Treaty was signed with the United Arab Emirates?
- Electronic invoicing is now a major topic in many EU countries?