Tax and Legal News

March 2023

Building a better working world

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Tax for the state budget

Let me start by suggesting that fair, balanced and just taxation is a thing of the past. Tax is a source of revenue for the state budget and the state budget is going to need a lot of it. Both at home and in most other countries. COVID losses, energy subsidies, social assistance to the needy, pension reform for an ageing population, new defence spending and much more will need to be financed. The world has changed.

In parallel, a systemic reform of international taxation may still be underway, but even there we can expect strong voices for filling state budgets rather than achieving fiscal beauty. Pillar I of the OECD is a nice idea. Taxation of income where the customers are. If this could be completed at some point in the future, we would get rid of transfer pricing, residency, permanent establishments and many other terribly complicated and confusing concepts. Life would be easier. However, the current proposal foresees its introduction only for large entities and only for a part of income. So we have to keep all those complicated concepts and learn the rules of Pillar I.

Pillar I should go hand in hand with Pillar II. It is a two-pillar reform. Pillar II is another beautiful idea – all corporations will pay a minimum 15% tax. If it is not collected by the domestic tax authority, it has to be paid somewhere else in the group. That's where the beauty ends. The complexity of the implementation rules exceeded all expectations. Those who have tried to read it understand. Pillar II was finally approved by everyone and we'll be implementing it.

However, we got stuck on Pillar I, with the French reportedly saying the US, Saudi Arabia and India were blocking the proposal. The EU directive implementing Pillar II keeps this in mind. If Pillar I fails, the European Commission is to come up with a proposal to address the challenges of the digital economy. I guess we'll be back to the digital tax here. The question is whether we won't get stuck again – perhaps again with the USA – as happened during the last attempt.

The windfall tax, for example, interferes with this seemingly systematic approach. Completely unsystematic, but we simply need the money. We have already written a lot about the windfall tax on this site, so we'll rather quietly watch who's first to bring a lawsuit because of it.

Much more creative is the Italian tax administration's attempt to collect VAT on something we all use for free while somehow suspecting that nothing in life is free. Simply put, they want Meta to pay $900 million in VAT. Access to their platforms is allegedly not free, but in exchange for the provision of personal data, and should therefore be subject to VAT as barter. Allegedly, similar considerations took place years ago in Germany, but they did not lead to a real crackdown. VAT is nicely harmonised in the EU, so we'll be watching to see how Italy fares and whether other Member States join in.

And what about the Czech Republic? Do we have any more treats in store after the windfall tax? Maybe. Perhaps the update of the Czech government's program statement published last week. The government no longer has the ambition to create a tax brake (tax burden ceiling). It no longer promises to accelerate depreciation on rental housing and other buildings, nor will it reduce VAT on the construction and renovation of flats, nor will social insurance be reduced by 2%. I think the trend is clear. But let's not despair, the new Director General of the Financial Administration of the Czech Republic promises to build an environment of mutual cooperation and return the Financial Administration to its reputation as a fair, just and client-oriented institution. So, we look forward to that.

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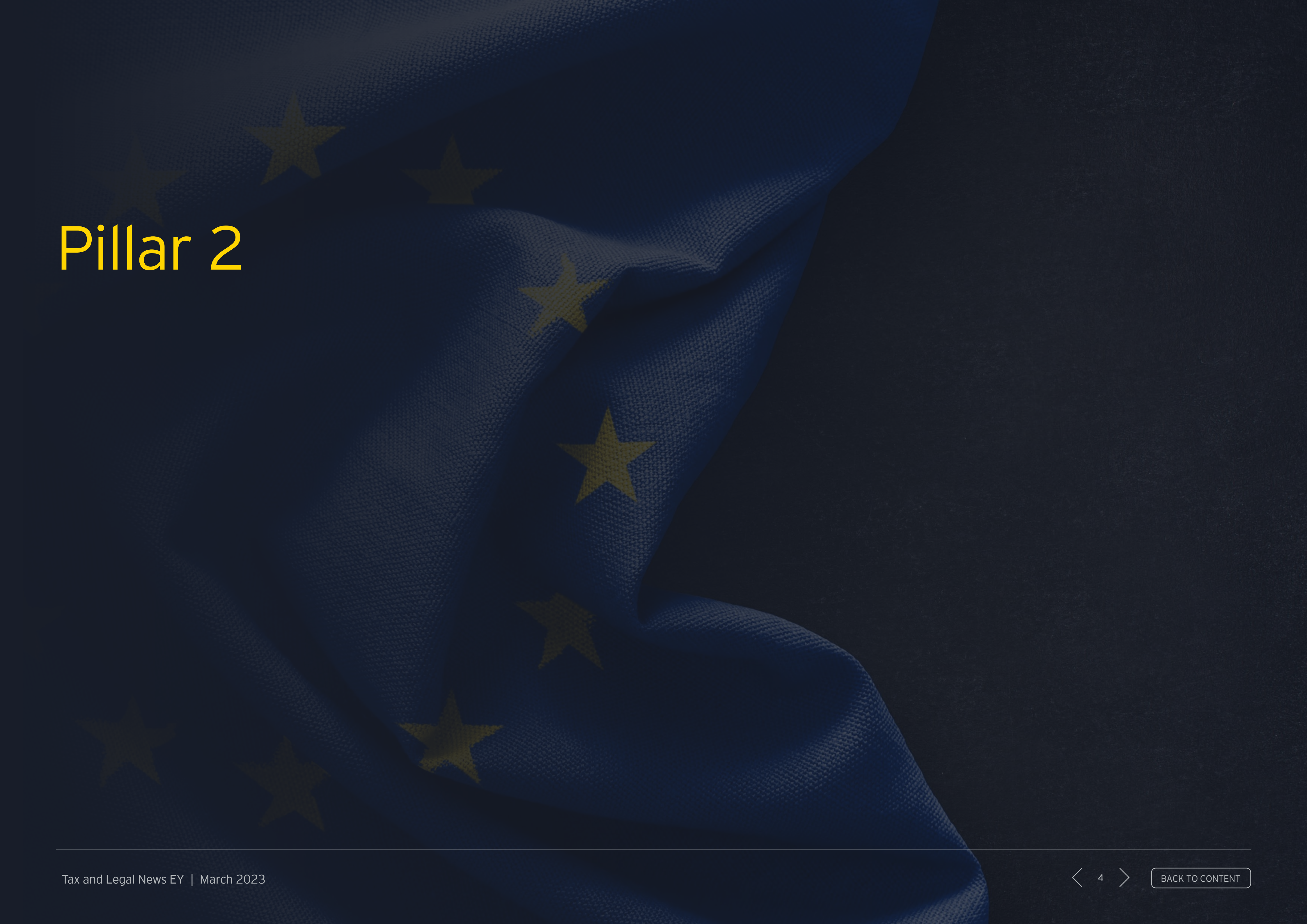

Pillar 2

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Pillar 2 of BEPS 2.0 – we need to start now

In the last issue of Tax and Legal News, I addressed four theses that we are encountering and trying to refute. Today I will add two conceptual notes:

Are the rules effective from 2024?

More or less yes. The EU directive is approved and provides for transposition of the rules by the end of 2023. The related bill is not yet available. Even a possible minimalist approach to implementation will bring many pitfalls, e.g. whether and how to transpose various provisions, important for business, which stem from the OECD Commentary or the OECD Guidance, into the Czech environment (in which taxes can only be imposed by law). The Ministry of Finance still has a few months to prepare the draft law, the rules are generally given by the Directive. We also expect Pillar 2 to be implemented in the Czech Republic from 2024. For the years 2024 to 2026, the safe harbour rules (which we informed you about in our Tax and Legal News for February 2023) are still in play, which may temporarily simplify the practical application of Pillar 2.

For completeness, I note that the Directive allows Member States to defer the introduction of Pillar 2 for up to 6 years if there are no more than 12 ultimate parent entities in that State, but I would not rely on this deferral. If there is a postponement, other Member States will levy additional tax under the undertaxed profits rule.

Is it necessary to do anything as the final Czech rules are not known?

It is. The rules are given. Although the EU Directive is not detailed enough and does not cover many practical aspects, I do not think that the Czech implementation will provide more detail. Companies around the world are doing impact assessments for individual jurisdictions based on the OECD rules and the EU Directive; only a few countries have draft or final local rules. More interpretations and commentary are coming in as time goes on, which may help resolve some areas, but there is nothing to wait for. Yes, we don't know how state governments will approach investment incentives, we don't know whether the new Accounting Act will also be implemented with the Pillar 2 rollout, and whether and how the new Accounting Act will be reflected in the Income Taxes Act. However, this does not preclude review of material items that may affect the calculation of the effective tax rate under Pillar 2.

A mere transition into the rules can be an interesting exercise, as not all items will be 1:1 for Pillar 2, e.g. (non)recognition for deferred tax assets may take on a new non-accounting dimension. And further. Which deferred tax assets/liabilities should be actually taken into account? How to treat intercompany transfers of assets that have taken place or will take place before the rules kick? Will it still be efficient to provide intercompany debt financing in the current way? Are the current accounting methods compatible with the Pillar 2 rules and don't they cause a reduction in the effective tax rate? These are just a few of questions that need to be answered before the actual rollout of the rules.

In addition, in our experience, getting the right data and in the right detail can be difficult. The level of detail of some data that was only needed for tax purposes (e.g. profit allocated to a permanent establishment) will now also be needed from an IFRS perspective. The right level of detail will be needed even if the group is safely above the 15% effective tax rate under Pillar 2 in all countries - taxes are about the burden of proof and the numbers on the return need to fit the detail.

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

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

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Withdrawal from the non-compete clause in employment contracts under the case law of the highest courts

The Labour Code allows the negotiation of a non-compete clause between the employee and the employer. The purpose of a non-compete clause is to provide the employer with time-limited protection against leakage of information to a competitor after the employee's employment ends.

Thus, the non-compete clause prevents former employees from disclosing valuable information to another employer or from using that information to benefit a business competitor of the former employer or in their own business. Such information means, in particular, information which has come to the knowledge of the employee in the course of employment and which is intended to be a trade secret or is of such a nature that, by obtaining it, a competing employer or company may gain a significant competitive advantage.

Legal conditions for concluding a non-compete clause

The Labour Code regulates the conditions for concluding a non-compete clause relatively strictly in order to preserve the constitutionally guaranteed right of employees to free choice of profession and the right to do business. This relatively strict regulation stems from the general premise of protecting employees as the weaker party to labour relations. The strict conditions laid down in the Labour Code are further developed by the extensive case law of the Supreme Court.

Therefore, in order to conclude a non-compete clause, the following conditions must be met:

- a non-compete clause must be concluded in writing and only in cases where the employee can reasonably be required to do so, having regard in particular to the nature of the information, knowledge and expertise in working and technological processes which the employee has acquired in the course of his or her employment and which he or she could use in a gainful activity identical to or competitive with the employer's business;

- the maximum duration of the non-compete shall not exceed twelve months from the end of employment;
- the employer must pay the employee reasonable financial compensation for each month in which the employee complies with his or her non-compete obligation in an amount equal to at least half of the employee's average monthly earnings;
- a contractual penalty may be agreed for breach of a non-compete clause, but it must be agreed in a reasonable amount and must correspond to the nature of the prohibited conduct; and finally,
- the employer can only withdraw from the non-compete clause for the duration of the employment relationship.

Withdrawal from the non-compete clause in Supreme Court case law

In relation to the withdrawal from the non-compete clause, the Labour Code generally provides that the employer may do so only during the employment relationship, without specifying the reasons for which it does so. These reasons have been gradually defined by a wealth of Supreme Court case law, which shows very narrowly defined possibilities for an employer to withdraw from a non-compete clause.

First of all, the case law goes beyond the statutory definition of the rules of the non-compete clause to imply that the employer may not withdraw from the non-compete clause for any reason or without stating a reason (even though the Labour Code does not require a reason). Thus, according to the settled opinion of the Supreme Court judges, there must be statutory grounds for withdrawal from a non-compete clause (e.g. a material breach of contract by the employee).

The employer may also withdraw from the contract if the reasons for withdrawal have been expressly agreed with the other party. However, these cannot be just any reasons. In particular, according to the Supreme Court, it cannot be contractually agreed that a non-compete clause may be waived for any reason or, for example, because of the employer's discretion to assess whether the employee has acquired sufficient information, knowledge and expertise in relation to work and technological processes in the course of employment.

The Supreme Court reached this conclusion in its judgment of 5 November 2020, file no. No. 21 Cdo 4779/2018. In this case, the employee and the employer agreed in a non-compete clause that the employer could withdraw from the clause *"by reason of the dissolution of the employer or a substantial part thereof" and if the "employer, in its sole discretion, concludes that it would be unreasonable and/or impractical for the employer to enforce or insist on the agreed non-compete against the employee and to pay the agreed monetary compensation to the employee, given the value of the information, knowledge, expertise in work and technological processes that the employee has acquired in employment with the employer or otherwise."* Prior to the termination of the employment relationship, the employer withdrew from the non-compete clause using the above contractual reason on the grounds that the employee had not acquired sufficient know-how that could be used in a comparable position with a competitor.

The Supreme Court has confirmed that if the parties anticipate that there may be circumstances in which the employee will not obtain the protected information, for example, because the duration of the employment relationship is too short, such circumstances may be contractually agreed upon as grounds for withdrawal. Such contractually agreed reasons must be specific, objectively determinable and must not allow for discretion on the part of either party. A contrary arrangement would be contrary to the law and any withdrawal from the non-compete clause based on it would have to be considered null and void, as in the above case.

Withdrawal from the non-compete clause according to the Constitutional Court

The Constitutional Court challenged the above-mentioned conclusions of the Supreme Court. In assessing the admissibility of an employer's withdrawal from a non-compete clause without stating a reason, the Court primarily dealt with the purpose of the non-compete clause as such. It summarized that, although it is an institution from which the employer and the employee derive mutual rights and obligations, it serves mainly to protect the interests and rights of the employer. Therefore, it is not possible to universally exclude the possibility of an employer withdrawing from a non-compete clause without giving a reason.

In the opinion of the Constitutional Court, the general courts must always support their assessment of the validity of the withdrawal from a non-compete clause in a sound, logical, comprehensible and convincing manner. Therefore, the court should only consider the employer's withdrawal as invalid if it is proven that the employer has abused its right to withdraw in the particular case. The Constitutional Court reasoned that only a withdrawal from a non-compete clause which is made arbitrarily and with a conscious abuse of the right by the employer will have to be assessed out of hand as invalid. Where the parties agree in a non-compete clause that they may withdraw without giving a reason, this provision must be assessed as primarily valid unless it can be shown that the employer has abused its right to withdraw.

Conclusion

The ruling of the Constitutional Court corrected and reversed the long-standing judicial practice of the Supreme Court in relation to the validity of withdrawal from a non-compete clause without stating a reason and effectively expanded the employer's possibilities to negotiate and apply the grounds for withdrawal from a non-compete clause as it needs in its practice, provided that the withdrawal does not manifestly abuse the employee's right as a weaker party to the employment relationship. General courts should only consider a withdrawal to be invalid if it can be shown in a particular case that the employer has abused its right to withdraw.

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

The Labour Code allows the negotiation of a non-compete clause between the employee and the employer. The Supreme Court has long held that a non-compete clause so negotiated cannot be withdrawn from without giving a reason, even if the parties expressly agree on the possibility of such withdrawal. This judicial practice has been disrupted by the Constitutional Court, which has now ruled that an employer may, by agreement with an employee, withdraw from a non-compete clause without giving a reason, provided that the employer does not abuse its right to withdraw.

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Transfer of real estate and some related VAT aspects

In today's article, we'll highlight some of the VAT considerations you should address if you plan to sell real estate. Whether it's a one-off transaction or a regular business, it's usually a material amount and an easily identifiable transaction for the tax authorities, with great potential for tax assessment. Moreover, the area of real estate is spread over many provisions in the VAT Act and there is extensive CJEU and Supreme Administrative Court case law.

The first step to proper taxation is to determine what is actually being sold, to whom and for what purpose. Often the subject of the sale is a collection of several properties and plots of land, where the principle of principal and ancillary supply will need to be applied and the so-called functional unit determined. The seller will have to deal to some extent with what the buyer's actual objective is. Nowadays, the exemption for the sale of land with an old shed or old utilities no longer stands.

A very complex issue is the sale of old buildings for demolition, which – according to the official interpretations of the tax administration – often does not lead to VAT exemption, as the buyer's target will most likely be the building plot. However, CJEU case law suggests that the correct answer may be different in some situations. It will also be important to see how the new methodology currently being prepared by the General Financial Directorate (GFD) will deal with this issue.

The principle of principal and ancillary supply must also be taken into account in the case of the sale of real estate together with fixtures and fittings. Items incorporated into the real estate are likely to follow the taxation of the real estate itself, whereas for movable equipment, the assessment may be much more difficult and require deeper consideration of the functional separability of these items from the real estate.

Similarly, the sale of the real estate itself must be distinguished from the sale of the company owning the real estate (the so-called special purpose vehicle or SPV). While in the first case the VAT payer will assess the tests for exemption or taxation of the sale of immovable property (goods) and possible adjustment of the input VAT deduction, in the second case it is a financial activity (sale of a share) and the real estate itself does not change owner.

No less importantly, the sale of real estate may qualify as the disposal of a going concern (i.e. the sale of a business or part thereof), which is not subject to VAT. This will be the case in particular where the real estate is transferred together with tenants (subject to other conditions). As the law does not allow for voluntary application of VAT, correct assessment in light of recent case law is essential to minimise tax risks for both parties.

But even in the case of a "straightforward" sale of real estate, there are many other steps for the seller to consider, including:

- The exemption or taxation of the sale is based on its age. The sale can generally be exempted from VAT after 5 years from the date of the first building permit or the first occupancy permit. In the event that the real estate undergoes a building alteration that meets the conditions of a "substantial alteration", the VAT exemption period will run again from the issuance of a new occupancy permit.

- If the conditions for exemption from VAT are met, the seller may opt for taxation with the consent of the VAT-liable buyer. In such a case, the reverse charge scheme will apply. This option may be advantageous for the seller to retain the input tax deduction claimed (however, if the buyer is not fully entitled to the VAT deduction, the related decision-making will be more complicated). However, reverse charge cannot be applied voluntarily if the conditions for exemption are not met.

- A specific situation may arise in the case of the sale of real estate for which the taxpayer could not claim a deduction at the time of acquisition because it was used only for exempt activities. Such sales are then also exempt from VAT and are not subject to the option to tax.

- Another point that the seller must keep in mind is the potential obligation to exclude the transaction from the calculation of the shorting coefficient. This does not apply to real estate if the sale is part of the ordinary course of business (typically recorded as inventory).

- An integral part of the sale of real estate is the obligation to assess the input tax applied and, if applicable, to refund or recover part of the VAT deduction. If the real estate is a fixed asset, its use is tracked for 10 years after acquisition. In practice, the time of acquisition may be disputed, especially if the real estate is not used and the owner is merely holding it for speculation. For real estate held as inventory, there is currently no time limit and the original deduction is subject to adjustment essentially indefinitely.

- When selling the real estate, it is also necessary to keep in mind the technical improvements made, which constitute separate property and are also subject to the obligation to adjust the input deduction for 10 years. Another relatively new obligation is to monitor so-called significant repairs to real estate exceeding CZK 200,000.

- A gratuitous transfer of real estate (gift or in-kind contribution) can also be classified as a supply of real estate. If input VAT was applied on the acquisition, both the gift and the contribution will be subject to VAT. Determining the taxable amount may not be straightforward. Furthermore, it is necessary to consider the possible VAT exemption when applying the 5-year age test for a building.

- A separate chapter is the application of the correct VAT rate when selling real estate that does not qualify for exemption. A reduced rate of VAT can be applied to selected social housing developments. In practice, we often deal with whether the same rate can be applied to other related transactions, such as parking spaces. The specific circumstances of a case will always be decisive.

Selling real estate is a challenging transaction in many ways and it is not easy to think of all the implications. Above we have tried to highlight at least some of them. For example, we prepare calculations of the tax implications of each option for our clients and help them time the sale of the real estate to be the most tax efficient. If you are interested, please contact the article's authors.

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The first step to proper taxation is to determine what is actually being sold, to whom and for what purpose. The subject of the sale is often a collection of several properties and plots of land, where the principle of principal and ancillary supply will need to be applied and the so-called functional unit determined. The seller will have to deal to some extent with what the buyer's actual objective is.

Judicial window

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Strict view of the Regional Court on proving consultancy services from a parent company

In this issue, we bring you an interesting judgment of the Regional Court (RC) in Brno on the issue of deductibility or proving consulting services from a foreign parent company (the case concerned year 2015).

Background

- The subsidiary entered into a management contract with the Austrian parent, whereby the parent undertook to provide extensive management and administrative services to the subsidiary (in particular, consultancy in various areas – strategy, research and development, machinery manufacturing, marketing activities, etc.).
- The parent was entitled to a remuneration of EUR 1,200 per person per day, which the subsidiary was obliged to pay.
- According to the contract, the scope of services to be provided was to be variable, according to the needs of the subsidiary, and the remuneration for administration was to be flexible based on the performance.
- The subsidiary provided a considerable amount of supporting documentation (tables, graphs, presentations, email conversations) for all invoices. At the oral hearing, it stated that some of the results of the services performed were sent to it by the parent by e-mail (e.g. support for the evaluation of planning calculations or preparation for the drawing up of documents for strategy and business planning), while others were received from the parent by telephone (international sales and service) or at face-to-face meetings and briefings (business development in Austria).

View of the tax administrator

- The tax office questioned the deductibility of these services. In particular, it criticised the company for failing to submit any documentation concerning the transfer of the services provided (service requests, acceptance reports, etc.).
- It further argued that the submitted documents failed in any way to show that they had been drawn up by the parent company. The documents often do not bear the parent's details and, on the contrary, they suggest (both formally and in terms of content) that

the subsidiary had a significant share in their preparation – they are written in the Czech language, a subsidiary employee is listed as the author.

- The exceptions are e-mail messages, which, however, except in a few cases, do not contain attachments that could be the output of the services in question, nor does the wording of the e-mails themselves reach such a scope or depth of content that the e-mail itself could be considered an output of the provided services.

- The tax office also accuses the subsidiary of failing to produce travel orders or other supporting documents (travel documents, invoices for any accommodation) for the alleged meetings with its parent's representative.

- According to the tax office, the vast majority of the submissions relate to the day-to-day management and operation of the business in terms of controlling, operational management of production, planning, monitoring of error resolution, etc. The regular cooperation of subsidiaries with their parent companies often does not meet the legal conditions for the recognition of tax deductible expenses of the subsidiary. The definition of services in the management contract is general and the company did not provide evidence relating to professional activities which could theoretically represent real added value.

- In addition, one of the persons who was to provide the services in question had been the subsidiary's managing director since 28 April 2015 and had also been the parent's managing director between April 2015 and April 2018. Therefore, according to the tax office, the involvement in the subsidiary's activities must be seen as the exercise of the functions of a statutory body.

View of the Regional Court (RC)

The RC sided with the tax administrator. Here are selected arguments:

- It was entirely irrelevant to the court that the subsidiary was unable to produce formal orders for services provided by its parent. Logically, these orders and other requirements could have been communicated between the representatives of the two companies in internal communications.

- However, a routine visit, organizational meeting or exchange of information between representatives of the two entities generally does not give rise to an allowable cost, according to the RC, as it does not go beyond the owner's normal interest.

- Conversely, if a subsidiary orders a comprehensive service to assess the foreign market into which it intends to expand, it can certainly claim the cost of such a service. Its provision costs the parent personnel and economic resources that cannot be justified by the normal interest in the owned company.

- In this case, however, it is not possible to draw a "dividing line" between the two types of contact and information exchange. In many cases, the subsidiary claims as a tax deductible expense services for which there is no clear output from the parent company to the subsidiary.

- Some of the partial benefits claimed could have been provided by the parent. For example, the documents on productivity and profitability progress, 2015 business planning, and the business planning calculation and strategy sufficiently demonstrate on their face that the subsidiary received the service. The subsidiary submitted graphs, tables or presentations in Czech or German. However, the evidence as a whole showed significant deficiencies for which the claim for deduction could not be allowed.

- First, in the vast majority of cases it is not possible to link the invoiced scope of an activity to its specific outputs. The invoices submitted show that the parent invoiced the subsidiary for a certain number of project days each quarter. It is not possible to determine how much of the reported time is attributable to which service. In addition to the time allocation, it is not even possible to determine whether this time was divided among several of the parent's staff and, if so, what their roles were. The first doubt is therefore that the declared services cannot be linked to the time invoiced and to the specific staff of the service provider.

- Advisory services for which the evidence suggests on its face that the parent could have provided them to the subsidiary cannot be separated from services that were virtually never proven. A detailed breakdown into the various sub-activities was not made. Even if the activities were carried out simultaneously, it was certainly possible to record what service took up how many of those 'concurrent' days.

  - Such records should have been provided to the subsidiary by its parent company, as both parties agreed in the management contract that the scope of the management services provided would always be based on the subsidiary's current needs. Thus, the provided supplies and remuneration for them should have been variable, and it is difficult to see how the subsidiary should have verified the number of hours worked for it by the parent company in a given quarter, other than on the basis of the statements provided to it.

  - Instead, it appears that the subsidiary routinely had the identical scope of provided services billed each quarter without requiring its parent company to provide the slightest evidence of the time and personnel resources expended on them. The subsidiary's lax approach, which was inconsistent with its own contractual documentation, meant that, as a result of the aggregation of services, each quarterly performance from the parent company had to be viewed as a single unit, which the subsidiary either succeeded in proving or not.

- There are doubts about most tables and charts (productivity documents, summary reports, budgets, planning), where the origin of their creation is absolutely illegible – there is no author or method of transmission. The lack of evidence is further exacerbated by the fact that it is not conclusively established how the documents submitted to the subsidiary reached it. An insignificant part of the documents was included in some of the e-mail messages, but there is no record of most of them.

- According to the court, the submitted e-mail communication is inconclusive. Only a marginal part of this communication contains attachments. Most of the e-mail messages contain text forwarded between different persons (including the subsidiary). Many emails are a few short paragraphs containing abbreviated wording (e.g. company names). The text of the emails cannot therefore be evidence that the subsidiary has received the claimed services.

- Mere mentions in the text of the emails of the names of companies that the subsidiary may contact do not, according to the court, fulfil the criterion of an advisory service. According to the RC, no reasonable commercial company could, in the ordinary course of business, reimburse its provider for a service whose output was of such low quality and added value. In other words, the mere recommendation of potential customers without the slightest sign of mediated communication with them cannot be seen as an advisory service, but at most as part of the normal communication within the group and an expression of the owner's interest in seeing the various parts of the group prosper.

It can be said that this decision goes beyond the existing case law of the Supreme Administrative Court in a number of aspects. We will see what this case will eventually bring in the next round. This is yet another judgment which shows that proving intra-group services is a tricky issue and the claims of the tax administration (and the courts) tend to increase gradually.

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

A routine visit, organizational meeting or exchange of information between representatives of the two entities, according to the court, generally does not give rise to a deductible cost, as it does not go beyond the owner's ordinary interest. Conversely, if a subsidiary orders a comprehensive service to assess the foreign market into which it intends to expand, it can certainly claim the cost of such a service. Its provision costs the parent personnel and economic resources which are not justified by the normal interest in the company it owns. In the present case, however, it was not possible to draw a line between the two types of contact and exchange of information.

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Holdings, abuse of law and withholding tax on dividends

Here we present an interesting judgment on the issue of holding company formation, dividend payment and abuse of law.

Background

- A holding company was established into which the shares of all partners in Companies 1 and 2 were sold.
- Subsequently, the holding company decided to distribute the profits of Companies 1 and 2.
- Subsequently, the holding company's liability to the former (and departing) shareholder of Companies 1 and 2 was satisfied out of that dividend income.
- The remaining shareholders, who also became shareholders of the holding company, were subsequently partially paid the purchase price of their shares and the new shareholder (CFO of Company 2) was paid an advance on the profit distribution.
- According to the tax authorities, the above-mentioned conduct was primarily aimed at obtaining a tax advantage in the form of an exemption on dividends from the subsidiaries to the holding company and, secondarily, at exempting the former shareholders from income tax on the transfer of their shares in Companies 1 and 2 for consideration, which originated in the aforementioned dividend income.
- Accordingly, the tax administrator assessed personal income tax withheld at a special tax rate (for the 2016 tax year) for direct payment due to the failure to withhold and remit tax in the amount of 15% on the dividend (to one of the subsidiaries).

Arguments of the Company

- There was no abuse of law precisely because of the economic and legal justification for the formation of the holding structure and the related transactions.

- In the long term, one shareholder was planned to leave Company 1 (25% stake) and Company 2 (52% stake).
- Another reason was to facilitate the entry of new shareholders. The CFO of Company 2 became a new shareholder.
- Business expansion is planned in the form of acquisition of other companies or new business opportunities, with the holding structure allowing better financing of individual companies.
- In view of the lack of available funds and the provisions of the articles of association, it was not possible to pay the dividends to the individual shareholders and then use these funds to buy out the shareholding of the outgoing shareholder.
- The reason for the chosen procedure was therefore to pay off the departing partner.
- The dividend was financed in full by the bank and was not paid in full - the holding company kept part of the money.
- The gradual reimbursement of the other shareholders' business shares ensured the exit of the departing shareholder, the possibility of drawing on the loan, the spreading of the business risk and the accession of the new shareholder without the absolute economic paralysis of a disproportionate loan drawdown.

Arguments of the Tax Administrator

- It did not find the objection concerning the lack of funds to buy out the shares of the departing partner justified. Companies 1 and 2 had some accumulated profits. Although these profits would not have been sufficient to pay for the business shares, there was the possibility of borrowing the remaining amount, which was eventually done. Nor can the possibility of the remaining shareholders committing themselves to the future payment of the price of the departing shareholder's shares be disregarded.
- The tax administrator also pointed out that in previous years there had been dividend payments in Company 2, which had happened at a time when the partners were already aware of the planned departure of one of them, so it was up to their discretion whether or not to use these profits to pay the shares of the departing partner.
- In relation to the activities of the holding, the tax administrator stated that the alleged intention to expand the business by acquiring other companies was not proven in any way in the tax proceedings. The tax administrator assessed this intention in terms of the nature of the transactions in 2016, when the holding company was established, and concluded that the objective of making acquisitions was not demonstrated at that time. The fact that in the following years the holding company found an outlet in the form of negotiations for future acquisitions, which were not successful, cannot be regarded as demonstrating the economic justification of the holding company structure in 2016.
- The tax administrator has identified specific non-standard circumstances of the case enabling the tax advantage to be obtained, e.g.:
  - the interconnectedness of persons in individual companies,
  - the temporal sequence and immediacy of steps,
  - the conformity of the amount of the dividend from the subsidiaries and the purchase price of the outgoing shareholder's shares,

- the low amount for which the new shareholder acquired its interest in the holding company, which had a fair value that was much higher,
- funds from loans from subsidiaries were used to pay for the transfer of shareholders' shares.

View of the Regional Court

The Regional Court sided with the tax administrator. Here are selected arguments:

- The intention of one of the shareholders to sell his shares in no way proves the economic rationality of the establishment of the holding structure and other transactions related to this establishment.
- Several variants of the solution to the above-mentioned plan have been offered, and the establishment of a holding structure for this purpose appears to the Regional Court to be purely expedient, purely driven by the desire to obtain a tax advantage.
- The Regional Court did not consider it economically rational to establish a holding structure for the purpose of buying out the shares of the departing shareholder, as other, more sensible options were available. The first possibility to present itself was dividing the shares among the other shareholders, but it is not true that such a transaction would be administratively demanding.
- In connection with the new shareholder's acquisition of a business share in the holding company, it cannot be overlooked that this new shareholder was paid an advance on the payment of profits by the holding company, while the same amount should have been spent by this shareholder to pay for his share in the holding company. He has thus, in effect, paid nothing for his participation in the holding company. The will to involve him in the business was thus enormous on the part of others. The Regional Court therefore considers the terms of his entry into the holding company to be very favourable and sees no reason why such compatible contractual terms could not have been established in the event of his joining Companies 1 and 2 without the holding company being established.
- The transfer of the shares described above could then be financed in the same way as the purchase of the outgoing shareholder's shares by the holding company, i.e. from the proceeds of the retained earnings of Companies 1 and 2, with the remaining purchase price of the shares being financed by a bank loan.
- It cannot be overlooked that some active operations with actual results, but which cannot be described as business expansion in the form of acquisitions, have only been carried out by the holding company since 2020. Until then, the holding company had not carried out any economically justified operations in the form of the acquisition of new companies alleged in the application. From 2020 onwards, some activity was carried out by the holding company, but it was administrative, marginal and the actual cooperation with the companies in question was always carried out by Companies 1 and 2 and was subsequently presented as being carried out by the holding company.
- The implausibility of the stated purpose is reinforced by the assertion that the nature of the holding was in fact a "pure holding", the purpose of which was merely to hold and manage its own holdings in subsidiaries. According to the Regional Court, that purpose, in the light of all the circumstances of the case described above, does not constitute a rational reason for the establishment of the holding structure, but on the contrary, it is indicative of its true purpose, which was to obtain a tax advantage.

- Although the subsidiary formally fulfilled the conditions of § 19(1)(ze)(1) of the Income Tax Act ("ITA"), this procedure was completely devoid of economic sense and its sole purpose was to gain a tax advantage, which can be inferred from the procedures leading to the establishment of the holding company and the subsequent transactions leading to the payment of business shares. This not only resulted in untaxed income from the dividend, but also provided funds to pay the purchase price for the transfer of the outgoing partner's business shares, which were exempt from income tax under § 4(1)(s) of the Income Tax Act. Therefore, both the objective and subjective criteria for abuse of rights were met.

In our view, this judgment further advances the rules for the application of the concept of abuse of law. We will therefore see what this case may bring in the next round. This is yet another judgment which shows that the area of intra-group holdings is a thorny issue and claims by the tax authorities (and the courts) tend to increase over time.

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

According to the court, the implausibility of the presented purpose is reinforced by the claim that the nature of the holding company was in fact a "pure holding", the purpose of which was merely to hold and manage its own holdings in subsidiaries. According to the Regional Court, this purpose, in the light of all the circumstances of the case described above, does not constitute a rational reason for the establishment of the holding structure, but on the contrary, it is indicative of its true purpose, which was to obtain a tax advantage.

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Did you know:

- The Government has issued an updated program statement?
- The SAC issued an interesting decision on the statute of limitation?
- Following questions from the public, the Ministry of Finance has confirmed its intention to extend the “tax deductibility” of aid to Ukraine for 2023?
- In February 2023, the EU Council approved a revised EU list of non-cooperative tax jurisdictions?