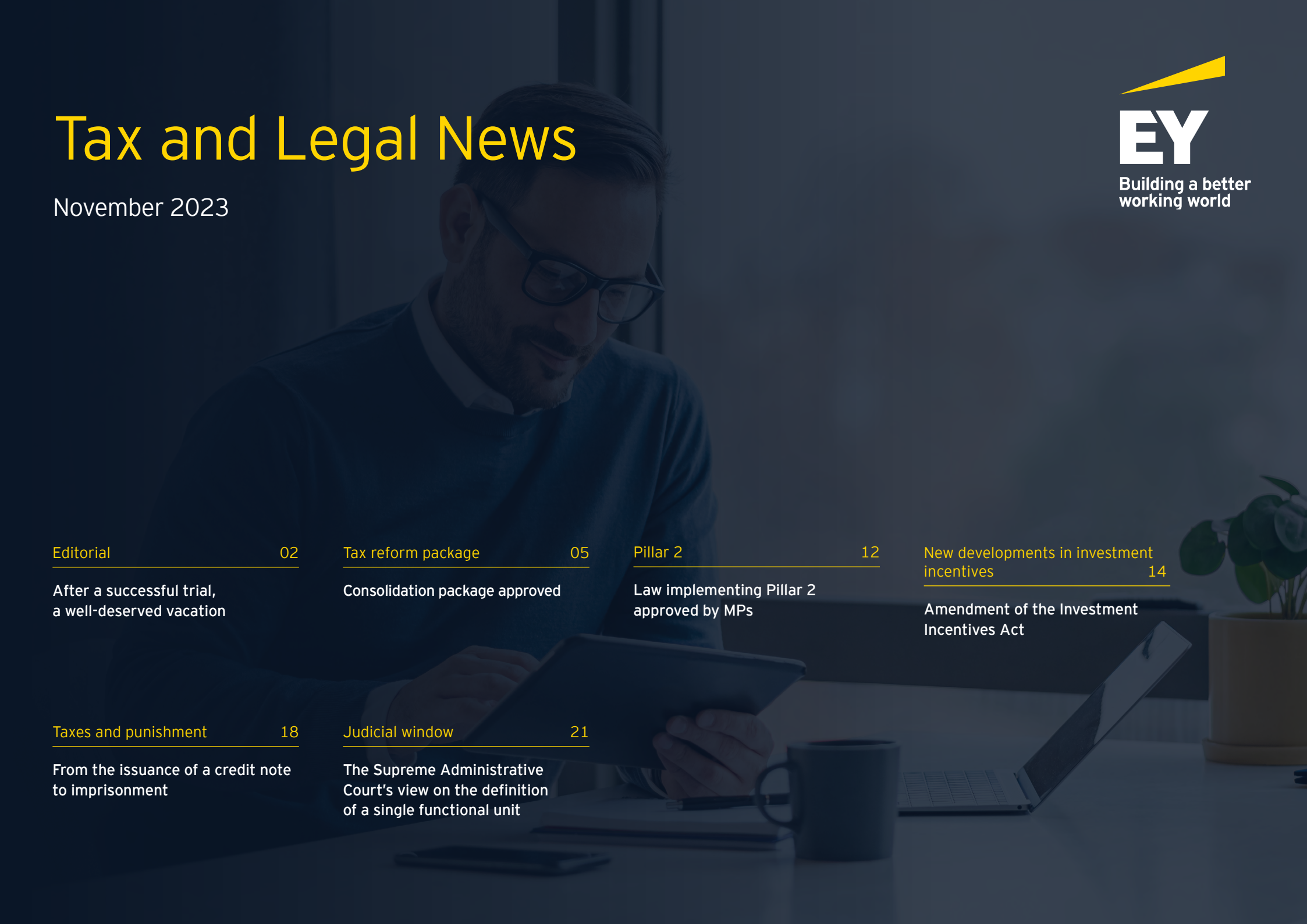
# Tax and Legal News

November 2023



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# After a successful trial, a well-deserved vacation

At first glance my November editorial might appear to be a description of the ideal scenario of how an attorney is rewarded for successfully representing a client in litigation, but it isn't. On the contrary, I'd like to briefly discuss a recent CJEU judgment that is likely to furrow the brows of attorneys (and even more so) clients. And relaxing on our vacations probably won't help much.

In Judgment C-57/22 of 12 October 2023, the CJEU addressed a specific preliminary question raised by the Czech Supreme Court, which in the original Czech court proceedings dealt with a dispute between an employee and her employer over the validity of a dismissal. The factual situation at issue was as follows: in the Czech courts, the employee challenged a notice of termination served by her employer in October 2013. After the competent court ruled that the dismissal was invalid, the employee returned to work in January 2017 under her original employment contract. It is relevant to the present case that, although the employee notified her employer in writing that she wished to continue working after challenging the validity of her termination, the employer did not assign her any work between January 2014 and January 2017.

Following her re-employment, the employee applied to the employer for leave to which she should have been entitled for the duration of the litigation, the period of three years from January 2014 to January 2017. The employer did not comply with this request on the grounds that the employee had not worked during the period of the litigation. The attentive reader may already have guessed the point of this story. Despite her employer's refusal, the employee failed to attend work on the days for which she had requested leave in July 2017, and her employer dismissed her in August 2017 for unexcused absences. The employee subsequently sued the employer for back pay for vacation time accrued during the previous litigation. This new dispute over the payment of wage compensation reached the Czech Supreme Court, which subsequently referred the matter to the CJEU for a preliminary ruling.

In particular, the Czech Supreme Court asked the CJEU to interpret Article 7(1) of Directive 2003/88/EC on certain aspects of working time. According to this Article of the Directive, the following shall apply: *"Member States shall take the necessary measures to ensure that every worker is entitled to paid annual leave of not less than four weeks in accordance with the conditions for obtaining and granting such leave laid down by national law or practice."* In its inquiry, the Supreme Court stated that under Czech law, an unlawfully dismissed employee who, without undue delay, notifies his/her employer in writing that he/she insists on continuing to be employed, is entitled to wage compensation in the amount of average earnings from the date of such notification to the employer until the employer allows him/her to continue working or the employment relationship is validly terminated.

In layman's terms, the Czech Supreme Court asked the CJEU whether the payment of wage compensation for the entire duration of the dispute is not sufficient protection for an unlawfully dismissed employee who did not actually work for the employer during that time. This distinguishes the Czech legislation from, for example, the Bulgarian legislation, which was the subject of another CJEU decision on working time and vacation entitlements, to which the CJEU has referred extensively in its case law.

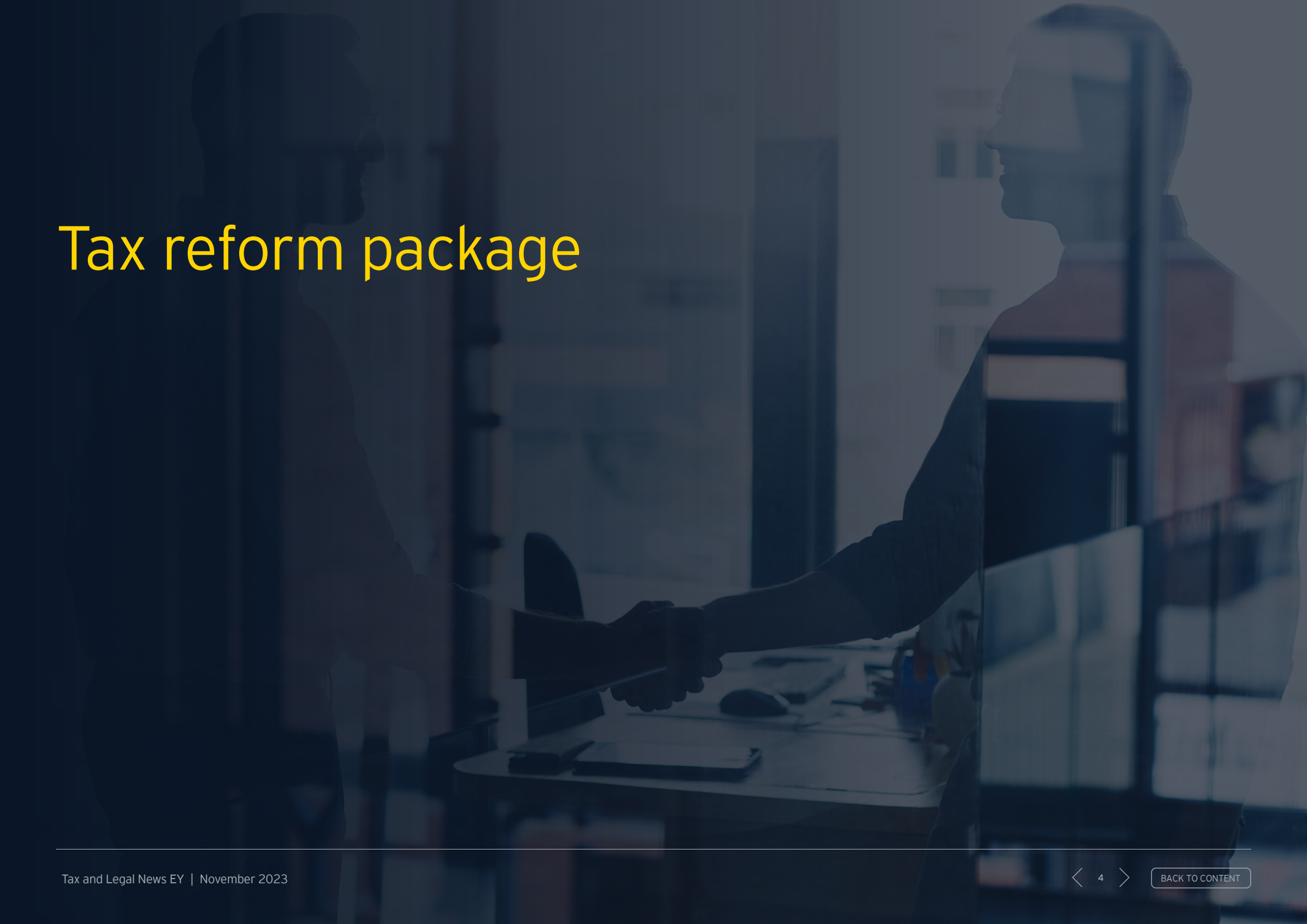
In the judgment in question, the CJEU went into some detail in assessing the objectives and legal context of the provision of the minimum holiday entitlement in Article 7(1) of the Directive. As might be expected, it held that the entitlement to paid annual leave could not be interpreted restrictively, since the employee must be regarded as the weaker party to the employment relationship, so it was necessary to prevent the employer from being able to restrict his/her rights. The CJEU stated that annual leave is primarily intended to allow employees to take a break from their work tasks and to provide time for relaxation and non-work interests. However, it went on to add that, though this purpose of leave is linked to the fact that the employee has actually performed some work, in certain specific situations entitlement to paid leave cannot be linked to a condition of actual work performance. One of these specific situations is wrongful dismissal, where the employee was unable to work as a result of the employer's wrongful conduct.

It also follows from CJEU case law that the Court considers the entitlement to leave and the entitlement to pay for taking such leave to be two components of a single entitlement. The purpose of the requirement to grant pay in lieu of leave is to place the worker on leave in a situation which, in terms of pay, is comparable to the period during which he/she works. This concept of two components of one entitlement also implies that the entitlement to annual leave includes, in addition to the entitlement to wage compensation for the period of leave taken, the entitlement to financial compensation for leave not taken on termination of employment. For this reason, the CJEU did not accept the reasoning of the Czech Supreme Court that wage compensation for the duration of the litigation is the only claim sufficiently protecting the unlawfully dismissed employee. This conclusion is a reversal of the existing decision-making practice of the Czech courts, as is evident from the argumentative position taken by the Czech Supreme Court in the proceedings before the CJEU.

What are the practical implications of this new CJEU judgment for us? When discussing with clients how to handle terminations, I sometimes feel a little inadequate when one of my main pieces of advice is "it's best to resolve the situation by agreement". Really valuable advice from a specialist, you might say. However, in situations where the grounds for termination are not "crystal clear", it is my practical experience with termination disputes, where the Czech courts have been very consistent in protecting the employee as the weaker party to the employment relationship, that leads me to this advice. The conclusions of the recent CJEU judgment described above may then be an additional motivation to look for room for agreement. In fact, a possible failure in a dispute over the validity of a termination notice may be even more expensive than the case law of the Czech courts has so far indicated. The employer will not only pay wage replacement for the entire period of the dispute, which often lasts several years, but also full vacation pay for each year in addition.

**According to a recent CJEU decision, an error in termination can be quite costly for the employer.**

# Tax reform package



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# Consolidation package approved

After many vicissitudes, both chambers of the Czech parliament have approved a package of tax reforms - the so-called consolidation package (more details HERE). This amendment will now go for the President's signature. Below is a brief summary of selected changes in the approved package.

## Corporate income tax/accounting[1]

- *Tax rate* - Increase the corporate income tax rate to 21% (from the current 19%).
- *Functional currency* - The possibility of keeping accounting records in a currency other than the Czech currency is newly introduced through the new institution of the accounting currency, which may be the Czech koruna, the euro, the US dollar or the British pound if this currency is also the so-called functional currency of the accounting entity. This should be the currency of the primary economic environment in which the entity operates. The accounting currency may be changed only at the first day of the accounting period. It may be changed back to the Czech currency only if the other currency ceases to be the functional currency of the entity. Our understanding is that the general goal is that, although the foreign currency cannot be used directly for the calculation of income tax, it can be used in the defined sub-steps necessary for the calculation of income tax (i.e. the conversion of only aggregated items). For more on this topic, see our alert HERE.
- *Option to exclude unrealised exchange rate differences* - A new option is given to exclude unrealised exchange rate differences from the tax base in the period of their creation (recognition) and to include them in the tax base generally (with certain exceptions) only in the period when the exchange rate difference is realised (notification to the tax administrator of entry into this regime is required).
- *Income tax report* - The Accounting Act introduces a new obligation (for selected entities) to prepare and make available an income tax report. This is an implementation of the obligations arising from the European Directive on public CbC reporting (for more details, see HERE). According to the transitional provisions, the income tax report is to be prepared for accounting periods beginning no earlier than 22 June 2024.

1 The changes will generally be effective for taxable periods beginning on or after 1 January 2024.

- *Sustainability report* - A new obligation to prepare and make available a sustainability report is introduced in the Accounting Act. Due to a phased-in introduction in several stages, this obligation is now imposed (for accounting periods commencing as early as 1 January 2024) only on entities that are (cumulatively) (i) a corporation, (ii) a public interest entity, (iii) would be a large entity even if it were not a public interest entity, and (iv) exceeded the criterion of an average of 500 employees per accounting period as at the balance sheet date (some exceptions apply).

- *Limit of deductibility for vehicles* - A new limitation is introduced, according to which only the proportional part of depreciation of a vehicle of category M1 (with certain exceptions) - put into a condition eligible for normal use from 1 January 2024 - calculated according to the ratio of the amount of the limitation of expenditure for such a vehicle - i.e. CZK 2,000,000 - and the aggregate of the expenditure incurred on such a vehicle - i.e. generally the purchase price (similarly for rent when acquired by means of a finance lease). The intention of the amendment is that, in relation to an M1 vehicle, generally no more than CZK 2 million can be claimed as an expense through depreciation and that the part of the depreciation that was not tax deductible at the time of possession of the car can no longer be claimed in the tax base (e.g. on sale). For more information on this topic, see our alert HERE.

- *Extraordinary depreciation for emission-free vehicles* - The possibility to apply extraordinary tax depreciation is extended for emission-free road motor vehicles acquired between 1 January 2024 and 31 December 2028.

- *Meal allowances* - On the employer's side, the tax deductibility of expenses for meal allowances should now be assessed in accordance with 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 (i.e. including meals) arising from a collective agreement, an internal regulation of the employer or a contract concluded with the employee should generally be deductible (see below in the section Personal Income Tax for related considerations regarding exemptions).

- *Non-monetary benefits* - Expenses for non-monetary benefits to employees in the form of Section 25(1)(h) of the ITA will be tax-deductible for employers if they are also exempt for the employee under Section 6(9)(d) of the ITA (see new exemption limitation below in the Personal Income Tax section).

- T*ax deductibility of selected benefits for employees' family members* - The provisions of Section 24(2)(j)(4) of the Income Tax Act (formerly Section 24(2)(j)(5)) are amended so that the employer's expenses for selected employee benefits provided not only to the employee himself but also to his family members are treated as tax deductible under the relevant conditions.

- *Silent wine* - The tax deductibility of silent wine as a marketing item up to CZK 500 is abolished.

- *Notification of income flowing abroad* - The payer's obligation to notify income flowing to a non-resident taxpayer that would be subject to withholding tax but is exempt from tax or is not subject to taxation in the Czech Republic on the basis of an international double taxation treaty is reduced to selected passive types of income (at the same time, the existing simplifying materiality limit for exemption from the notification obligation will apply only to selected income). This new rule could be applicable already to income for 2023.

- *Ukraine/donations* - Income tax measures to support charitable activities - in particular aimed at helping Ukraine and its population (under Law No. 128/2022) are generally extended for 2023 under the existing conditions

## Personal income tax/employment[2]

- *Reduction of the threshold for applying the higher tax rate* - The threshold for applying 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, for the income tax on employees' monthly payroll, the monthly limit for applying the higher tax rate will be reduced from four times the average wage to three times the average wage when calculating the advance payment.

- *Employee Benefits* - For defined benefits under Section 6(9)(d) of the ITA, an aggregate limit for tax exemption (and therefore insurance premiums) of half of the average wage will be introduced (for 2023, the limit would be CZK 20,162 per year).

- *Employer-organised events* - Income derived from an employee's (or family member's) participation in a sporting or cultural event organised by the employer will now be specifically exempt from tax. According to the Explanatory Memorandum, these should be events (i) of a "non-public" nature, (ii) which employers usually organise for employees in a given form and scope, (iii) organised "occasionally" (e.g. Christmas parties, company anniversary celebrations or children's days), (iv) which are "usual" or "reasonable" in the context of the circumstances. According to the Explanatory Memorandum, the criterion of frequency is not met by events held regularly (e.g. parties held on a weekly basis) and the criterion of reasonableness is not met by, for example, holding a Christmas party in an exotic destination or in other quite exceptional circumstances. Such income will therefore not be affected by the new aggregate limit for the exemption of employee benefits mentioned above.

- *Meals* - The exemption conditions for the provision of meals to employees are aligned. The current exemption applicable to the so-called meal allowance will generally also apply to meals provided in a non-monetary form (meal vouchers, company meals).

- *Repeal of the tax exemption for so-called managerial flats* - According to the transitional provision, the repeal should not affect persons who resided in the flats before the law came into force.

- *Private use of an emission-free car* - The non-cash income of an employee who has an emission-free car for business and private use will be only 0.25% of the purchase price of the car.

- *Restrictions on the spouse discount and other discounts* - The conditions for applying the spouse discount will be tightened; in addition to the condition of the spouse's income not exceeding CZK 68,000 for the tax year, 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. The student discount and the discount for the placement of a child (the so-called pre-school fees) are abolished completely.

- *Capping the exemption of income from the transfer of securities from 2025* - The consolidation package introduces a capping of the exemption of income from the transfer of shares in corporations and securities from personal income tax at CZK 40,000,000 per tax year. The effectiveness of this measure is postponed by one year, i.e. as of 1 January 2025 (including the related possibility to "revalue" the acquisition value of shares and securities as of 31 December 2024). More on this topic in our alert HERE.

2 The changes will generally be effective from 1 January 2024.

- *Taxable foreign exchange gains* - The exemption for foreign exchange gains on the exchange of money from a foreign currency account is abolished (today's Section 4(1)(ze) of the ITA).

- *"General" exemption limit* - A "general" limit of CZK 50,000 is introduced, within which certain other income of the same kind will be exempt.

- *Self-employed persons' reporting obligation* - Persons with income from self-employment will have an extended reporting obligation if certain conditions are met and zero tax liability.

- *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 new sickness insurance.

- *Tightening of the rules for "special limited" contracts* - Tightening of the rules for the exemption from paying insurance premiums in the case of special limited contracts (currently up to CZK 10,000). The limit varies depending on whether the employee has a special contract 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 special contract 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 liable to pay insurance premiums for both himself and his employer. More details in our alert HERE.

- *Self-employed person's assessment base* - The annual assessment base limit 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 advances for self-employed persons* - The minimum monthly assessment base for self-employed persons is gradually increased, from the current 25% of average wages (for 2023), by 5% for each subsequent year (i.e. 30% for 2024) to a final 40% of average wages from 2026.

## VAT/consumption taxes/energy taxes[3]

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

- *VAT on beverages* - There is a significant change in the taxation of beverages. When beverages are sold as goods, it will be possible to include drinking tap water and certain liquid dairy products in the reduced VAT rate. Other alcoholic and non-alcoholic beverages will be at the standard rate of VAT. As part of service only the supply of drinking tap water and selected dairy drinks will also be eligible for the reduced rate. The supply of other beverages will be included in the standard VAT rate.

- *VAT on transport* - Non-scheduled land and water public passenger transport (e.g. line transport of employees of a company, transport of pupils to the theatre, but not taxi services) is moved from the standard to the reduced VAT rate.

- *VAT on books* - Books meeting the definition of the law will be exempt from VAT with a right to deduct tax, both in physical medium (paper, CD, DVD) and in electronic form, including audiobooks.

- *VAT on newspapers, magazines and periodicals* will be taxed at a 12% VAT rate regardless of the frequency of publication. The same applies to their electronically provided version.

3 The changes will generally be effective from 1 January 2024.

- *VAT on medical and diagnostic equipment* - The condition "normally intended for the exclusive personal use of the sick or disabled for the treatment of illness, disability or the alleviation of their consequences" will be deleted. All medical devices and in vitro diagnostic medical devices that are intended for single use are proposed to be included in the reduced rate. Furthermore, the verbal description of some items is being changed, for example, contact lenses, spectacle frames and certain devices will be explicitly listed.

- *VAT limitation on the right to deduct for passenger cars* - A limit is set on the amount of input VAT that can be claimed on the acquisition of a passenger car that is a fixed asset. This maximum amount of deductible VAT is CZK 420,000 and includes any technical improvements. The limitation does not apply to taxpayers who acquire passenger cars for the purpose of resale (i.e. as goods). However, if there is a change of use and the car originally purchased as goods is classified as fixed assets, the VAT payer must reduce the VAT deduction originally claimed when exceeding the limit.

- *Other VAT* - Services such as municipal waste collection, transport, disposal and processing, 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, supply of firewood, domestic scheduled air transport, supply of cut flowers and decorative foliage will also be moved to the standard VAT rate.

- *Excise duty on tobacco products* - Excise duty on cigarettes, cigars and cigarillos and smoking tobacco is increased by 10% for 2024 and 5% each year from 2025 to 2027. A new tax on shisha tobacco will be introduced.

- *Excise duty on heated tobacco* - To be increased by a regular 15% each year for the next 4 years.

- *Excise duty on other tobacco products* - A new excise duty on other tobacco products (chewing and snuff) will be introduced from 2024. The tax rate will be gradually increased over 4 years in a scheme of 0.4 - 0.8 - 1.2 - 1.7 CZK/g of tobacco contained in the product.

- *Excise duty on tobacco-related products* - From 2024, a new excise duty on tobacco-related products will be introduced - the tax rate will increase gradually over 4 years, namely for e-cigarettes in a scheme of 2.5 - 5.0 - 7.5 - 10 CZK/1 ml of refill and for nicotine sachets 0.4 - 0.8 - 1.2 -1.7 CZK/g.

- *Excise duty on alcohol* - The duty on alcohol is to be increased periodically over a period of 3 years (2024-2026), with the increase to be carried out in a scheme of 10 + 10 + 5%. The amount of security for the tax warehouse operator is also increased.

- *Mineral oil excise duty* - The exemption for aviation fuel for any domestic transport (including air ambulance) is abolished.

- *Mineral oil tax refund* - The refund on mineral oils used for metallurgical or mineralogical processes is abolished. However, it will be possible to claim an exemption for part of the mineral oils or to claim a refund of part of the excise duty when used for heat production.

- *Green diesel* - The procedure for refunding excise duty on green diesel will be simplified.

- *Energy taxes* - Exemption from tax on electricity, gas and solid fuels when used for metallurgical or mineralogical processes is abolished.

### Gambling tax

- The current rate of 35% is maintained for lotteries and technical games. For other games of chance, the tax rate increases from 23% to 30%.
- The minimum tax on gaming machines is increased from the current CZK 9 200 to CZK 13 400.

### Real estate tax

- In particular, property tax rates are increased to an average of approximately 1.8 times.
- Municipalities gain more power to regulate the taxation of agricultural land.
- A new inflation coefficient is also introduced.

If this is an area of interest to you, please contact the authors of this article or your usual EY team.

**After many vicissitudes, both chambers of the Czech parliament have approved a package of tax reforms - the so-called consolidation package. This amendment will now go for the President's signature.**

# Pillar 2

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# Law implementing Pillar 2 approved by MPs

We keep you informed about the development of the draft Czech implementation of the Pillar 2 rules, i.e. the draft law on top-up taxes for large groups, the transposition of the EU Directive on ensuring a global minimum level of taxation of large groups.

The proposal has been approved by MPs and goes to the Senate.

A great tax revolution is just around the corner and we're happy to help you with this complex issue.

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

**The implementation of the Pillar 2 rules in the form of a bill on top-up taxes for large groups has just been approved by MPs and is heading to the Senate.**

# New developments in investment incentives

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# Amendment of the Investment Incentives Act

At the end of October, the Chamber of Deputies approved an amendment of the Investment Incentives Act, which we covered in our February Tax and Legal News.

### Approval of investment incentive applications

The Investment Incentives Act amendment should abolish the obligation to submit every application for an investment incentive to the government for consideration, so the decision should again be made by the Ministry of Industry and Trade on the basis of the opinions of the ministries concerned. Specifically, the Ministries of Labour and Social Affairs, Finance, Agriculture and Environment, which, together with the Ministry of Industry and Trade, will assess the prerequisites for meeting the general and specific conditions for granting investment incentives. In addition to the conditions and obligations set out in the Investment Incentives Act and other implementing regulations, the ministries concerned should also assess the benefits of the investment project for the State and, on the basis of this assessment, issue binding opinions in which they agree or disagree with the granting of the investment incentive.

Only applications relating to strategic investments, i.e. investment projects where material support is provided for the acquisition of tangible and intangible assets, should continue to be submitted to the government. This financial contribution is a direct cost paid out of the state budget (instead of part of the income tax rebate, which is typically the main form of investment incentive). For this reason, it is left to the government to decide and to take into account current state budget possibilities. Therefore, the government will not decide whether to support the project as such, but only whether or not to release direct state budget funds to support it.

### Effectiveness

The amendment must still be approved by the Senate and signed by the President. The amended law should then enter into effect on the 15th day after its promulgation.

According to a transitory provision, it should be possible to apply the amended Act to applications submitted before the amendment takes effect, if they have not been decided by then, which is expected to increase the success rate of existing applicants for the investment incentive.

### Amendment of the Implementing Regulation to the Investment Incentives Act

For the sake of completeness, we reiterate that the amended implementing regulation on the provision of investment incentives entered into force in April this year. Investments targeting the listed areas can receive an investment incentive in the form of material support for the acquisition of tangible and intangible assets of up to 20% of eligible costs in all regions, without having to meet the higher limits on the value of acquired tangible and intangible fixed assets and the higher job creation rates set for strategic investment projects.

### Energy savings and transformations

The amended regulation extends support for the production of technologies and equipment that will contribute to energy savings and energy transformation. A list of these selected products is set out in a newly added separate annex to the Government Regulation. These are mainly products for which a shortage or partial unavailability on the market has been identified and where there is a need to support the increase of their production capacity and to achieve greater Czech self-sufficiency in their production. However, the applicant will also have to demonstrate that, in the case of the intended investment, the products are intended for the production or storage of energy from renewable sources, for increasing energy efficiency or for reducing the energy consumption of buildings. These investments will not have to meet the higher value-added thresholds (we discuss these thresholds in more detail below).

The list of selected products to be newly supported includes heat pumps, photovoltaic systems, solar thermal systems, solar hybrid systems, heat recovery units and solar thermal panels, nuclear reactors and non-irradiated fuel cells, steam generators and condensers, water turbines, water wheels and their controllers, wind turbines, wind-powered generating sets, electrolysers for the production of hydrogen from renewable energy sources, hydrogen fuel cells, meters for the supply or consumption of gases, liquids and electricity, battery storage for electricity from renewable energy sources, insulation materials used as thermal insulation for structures and piping in the construction industry, charging stations for electric vehicles, filling stations for hydrogen electric vehicles, hot water boilers for biomass and electricity for indoor heating, power chips, traction batteries for electric vehicles and electric motors for electric vehicles.

### Strategic autonomy

The current international situation and the unavailability of certain raw materials, components and technologies reinforce efforts to increase strategic autonomy. As a traditional industrial country, the Czech Republic is heavily dependent on supplies from Asia for certain sectors and technologies, which, as recent history has shown, can be disrupted. This then results in a shortage of certain raw materials, components and technologies, which can lead (and in several cases has already led) to the suspension of production of some key sectors of Czech industry. The European Commission has already responded to this situation with legislative initiatives that include public support for key investments by Member States.

The supported areas of research and development therefore include other areas related in particular to semiconductor components. Specifically, R&D in the production of semiconductor substrates for electronic applications, R&D in the production of integrated circuits, R&D in the design of digital integrated circuits, R&D of volatile and non-volatile memories based on integrated circuits and other semiconductor technologies, R&D of optical circuits and other optical components for computing tasks, R&D of hardware elements of quantum networks, R&D of semiconductor elements of quantum computers, R&D of quantum computers.

### Higher added value

The Government also supports the creation of a long-term competitive advantage of the Czech Republic based on the use of knowledge and innovation. This is to be achieved, among other things, by more targeted support for higher value-added investments. The new government regulation therefore modified the conditions for obtaining the investment incentive through higher value-added requirements as follows:

- The condition of higher value added has been extended to all regions of the Czech Republic, except for regions with unemployment of at least 7.5% (only the Karviná district currently meets the exception);
- The requirement to spend funds in collaboration with a research organisation has doubled from 1% to 2% of eligible costs;
- Mandatory share of R&D staff increased from 2% to 3%.

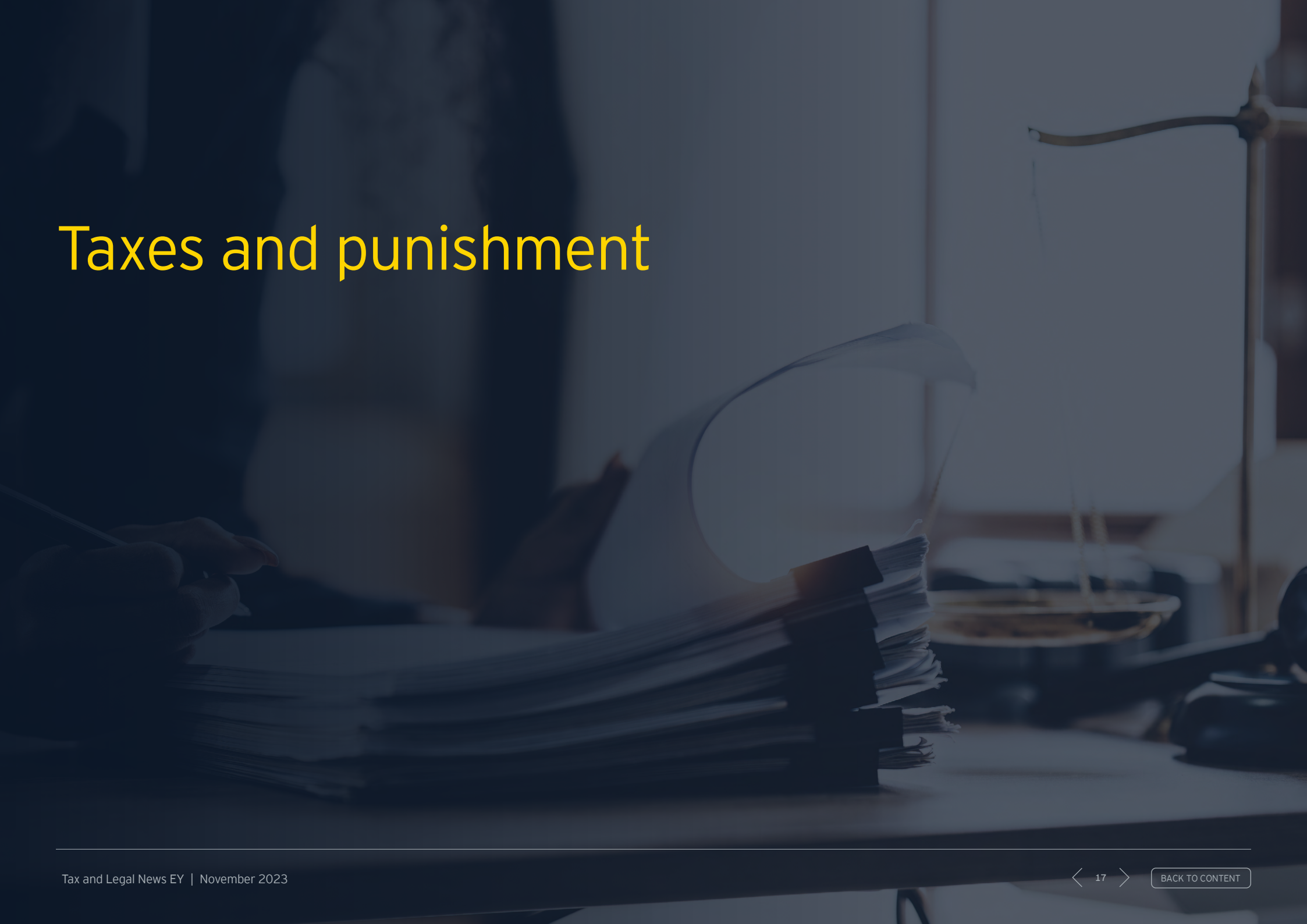
The wage criterion for the condition of higher added value of productive investments is now demonstrated by the total average monthly gross wages of employees of the recipient of the investment incentive in the place of implementation of the investment project, which should be higher than the average monthly gross wage in the region as published by the Czech Statistical Office.

Certain strategic investment projects should then be exempted from the higher value-added limits described above, e.g. the aforementioned investment projects aimed at increasing the production capacity of products needed to implement the necessary energy transformation of the Czech Republic.

If you are planning an investment exceeding CZK 80 million (CZK 40 million is sufficient in selected regions), which meets the condition of higher added value, or falls into the preferred categories described above, which are not subject to this condition, the application for an investment incentive may have a higher chance of success if the amendment is approved.

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

**The Investment Incentives Act amendment should remove the obligation to submit every investment incentive application for government consideration, which could increase the success rate of applicants.**



# Taxes and punishment

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# From the issuance of a credit note to imprisonment

The Constitutional Court rejected the constitutional complaint of a company that was sentenced to a fine in criminal proceedings for evasion of a tax, fee or similar compulsory payment by issuing a credit note and unlawfully reducing output VAT.

## Background and judgments

At the end of last year, the Supreme Court issued rather strict decision 3 Tdo 952/2022-290, in which it rejected the appeal of a legal entity and its authorized representative who were found guilty of the crime of tax evasion committed at the attempt stage. This dispute has now been concluded by the Constitutional Court in IV.ÚS 622/23, according to which there was no violation of the complainant's fundamental rights.

The subject of the dispute was a single credit note issued by the company to its customer while the company failed to prove to the tax authorities that the reduction of the taxable amount for VAT purposes was justified. The situation was one in which the company, in its capacity as a supplier, had entered into a work contract with the customer. Due to mutual disputes, the contract was withdrawn and a settlement agreement was subsequently concluded. According to the contractor, part of the price of the work remained unpaid and therefore, almost a year after the termination of the cooperation, he issued a credit note according to Section 42 of the VAT Act and reduced the tax paid. The customer immediately returned the credit note to the supplier as unjustified, yet the supplier included it in its accounting and VAT return.

The tax administrator did not recognise the reduction of output tax and assessed the tax in the amount in question. The company paid the tax in due course. Nevertheless, the tax proceedings proceeded to criminal proceedings. A fine of CZK 120,000 was imposed on the supplier as a legal entity and a 12-month prison sentence suspended for 2.5 years was imposed on the natural person authorised to act for the supplier on the basis of a power of attorney.

Both courts dealt in detail with the intentionality of the crime. The complainant defended himself by arguing that his conduct was caused by a misinterpretation of the tax rules rather than by an intention to extract a tax advantage (i.e. he acted under a negative error of fact). This argument did not hold up in the courts.

In its ruling, the Supreme Court clarified that not only the mere unjustified reduction of an actually existing tax liability constitutes tax evasion, but so, too, does the false pretence of a fact from which the State is obliged to provide a certain benefit (e.g. an excessive VAT deduction).

As far as criminal intent is concerned, it is sufficient to prove indirect intent. In performing an assessment, inferences must be made from the entire conduct of the perpetrator, such as the methods of interference with accounting, the manner of keeping and storing accounting and other documents, oral and written statements made to government authorities or business partners. The Supreme Court therefore agreed with the lower court that the accused must have known that the tax document in question had no real basis, yet knowingly introduced it into the accounting records and subsequently into the VAT return, when at this stage his actions were already directly aimed at extracting a tax advantage. The legal person and its authorised representative therefore acted at least indirectly. The Supreme Court also added that ignorance of tax regulations, or misinterpretation of tax law, is an error of law, not an error of fact, as had been argued by the complainant.

The company's other objection was also unsuccessful. It claimed that the lower court failed to gather the evidence it had requested: an expert report in the field of economics, which would have confirmed that the payments received from the customer did not cover the price of the work delivered. According to the Supreme Court, however, such evidence is not crucial in the assessment of the guilt of the accused and the accused legal entity, or is not directly related to the committed crime. The question of the financial or business situation between the two entities is not at issue in the proceedings.

Thus, the Supreme Court found no error in the lower courts and did not uphold any of the contractor's objections.

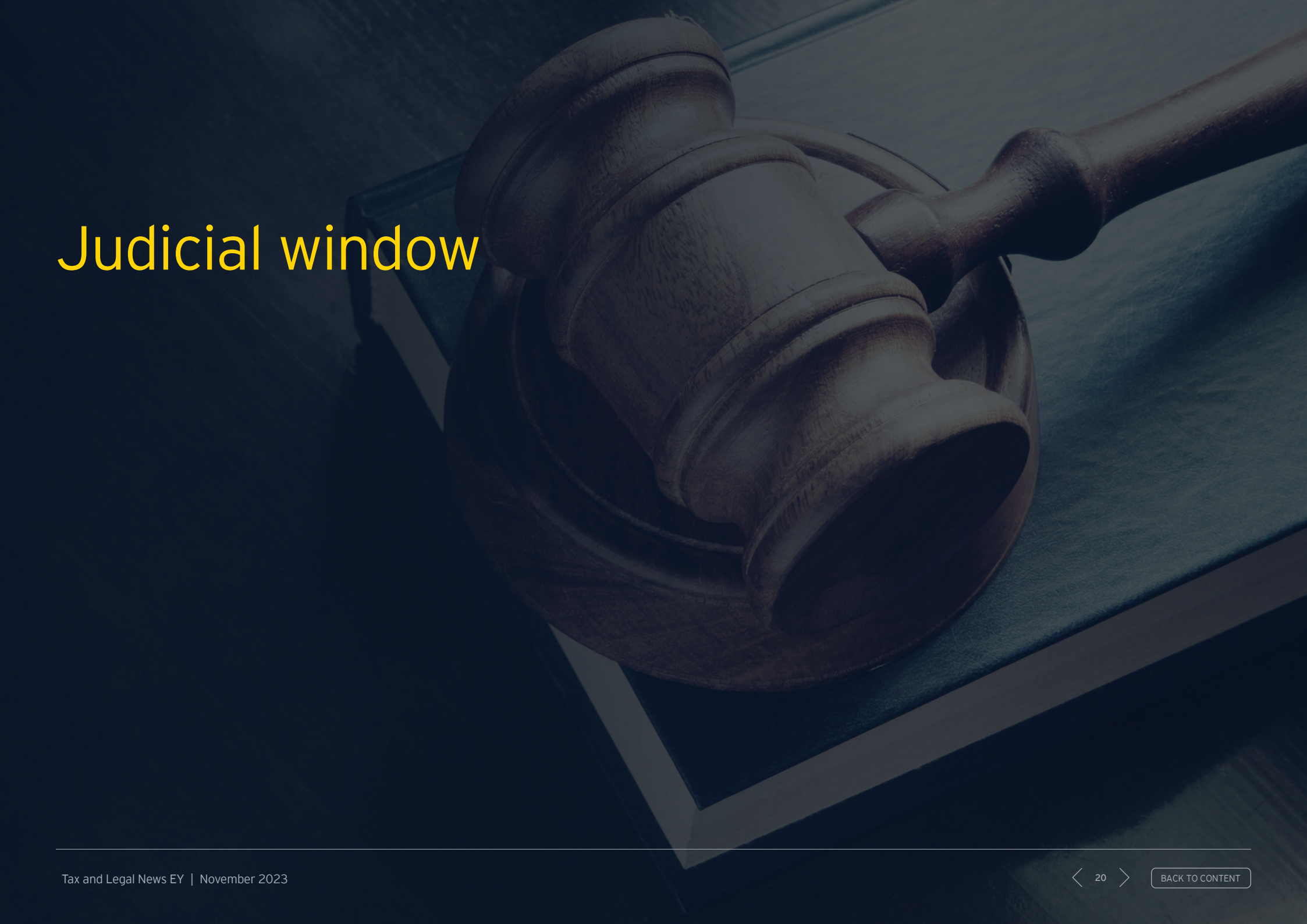
In the subsequent constitutional complaint, the contractor used the same objections that had been used in the previous proceedings, i.e. the failure to consider an expert opinion and the failure to fulfil the subjective aspect of the offence. However, the Constitutional Court did not identify any acts in violation of the contractor's fundamental rights and freedoms and thus found the constitutional complaint unfounded.

In our view, the courts' conclusions are relatively strict. Unfortunately, the details of the historical settlement of the dispute between the companies are not entirely clear from the description of the situation in the judgments, nor is it clear whether the supplier could have used the tax base adjustment in the case of bad debts. In any case, it is obvious that such commercial disputes cannot be resolved by creative interpretation of tax laws.

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

**Issuing a credit note without a genuine legal reason has been classified by the courts as the offence of attempted tax evasion. The legal entity and its authorised representative were sentenced to a fine and a prison sentence.**

# Judicial window



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# The Supreme Administrative Court's view on the definition of a single functional unit

In this issue, we look at a judgment of the Supreme Administrative Court (SAC) on the topic of classification of a power plant into a depreciation group with regard to its functional purpose.

## Background

The company placed a stationary power plant in a former boiler house, creating a new backup power source. The tax authority assessed corporate income tax on the incorrect classification of the power plant in the depreciation group.

## View of the tax administrator

- It is an interconnected system consisting of a technological and construction part, which from the point of view of the construction work enables its function and purpose.
- Although under the original GFD Guideline D-6 (now D-59), power generation equipment may be separate movable property, the application of the regulations must always be assessed on the merits of the particular case, taking into account the building's structural and technical characteristics, function and purpose.
- The tax administrator carried out an onsite investigation, evaluated the building permit, the building approval, the work contract and concluded that it was a technical improvement of the building.
- Since it was a backup power source, the tax administrator decided to refer to the definition of modernization (extension of the equipment or usability of the property), which is considered a technical improvement, as a further argument for its conclusion.

## View of the Regional Court:

The Regional Court sided with the tax administrator – a selection of its arguments:

- In order to assess whether the disputed item is part of the building or is separate property, it is first necessary to define the function and purposes of the building and the disputed item. If the function and purpose of the two objects are similar, then they form a single functional unit.

- The removal of the power plant equipment would render the power plant building inoperable and it would not fulfill its function and purpose.
- The Regional Court further supported its reasoning by referring to the building permit and the building approval, according to which the buildings were intended for the operation of a backup energy source.
- Nor was the court persuaded by the company's argument that the buildings served only as a "shell" to protect the plant.

### View of the Supreme Administrative Court (SAC)

The SAC sided with the tax administrator – a selection of its arguments:

- A strictly case-by-case approach is required for the application of the Annex to Guideline D-6 (now D-59). Equipment that is required by the building (in terms of the Building Act) for the function and specific purpose of the building will normally form part of the building for the purposes of the Income Tax Act.
- In making its decision, the SAC also relied on the building permit and the building approval issued for the construction.
- The analogy between a lathe or milling machine (reference to an earlier SAC judgment) and a power plant is not permissible, since the relationship between the machine tool and the building is not as strong as in the case of a power plant and a building.
- As a supporting argument, the court referred to the required structural engineering of the building and the safety regulation regime for the purpose of operating the plant.

### What can we take away from this?

Transfer pricing or intra-group services are not the only areas that the tax authorities can look at. Even the question of the correct classification of an item in a depreciation group will come before the courts from time to time. Notwithstanding existing case law, it remains difficult to define a single functional unit requiring individual assessment of each specific situation. Since the cost of an investment project is usually significant, any assessment and penalties are not insignificant from the taxpayer's point of view. If you plan to make an investment, we advise you to check all impacts (including tax ones) in advance.

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

**According to the SAC, in assessing whether the disputed item is part of the building or a separate asset, a strictly individual approach must be applied and a link must be sought between the acquired item and the underlying asset. If the relationship is strong enough, as in the case of the power station and the building, it may be a technical improvement of the building. When undertaking an investment project, we generally recommend that companies take care to properly assess the tax treatment of the related costs.**

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


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ED None

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## Did you know:

- Decree No. 79/2013 Coll. on occupational health services and certain types of post-accident care has been amended?
- The Supreme Administrative Court refused to refund VAT to the organiser of a demonstration event?
- In the second half of November, applications will be accepted for a call for the digitalisation of production processes in enterprises?
- During the consideration of Parliamentary Bulletin 474, which, among other things, discusses the introduction of a retirement savings product, an amendment was introduced regarding the taxation of employee stock plans?
- EY is organising a webinar on transfer pricing focussing on recent developments in case law and practical experience in the form of case studies?