Tax and Legal News

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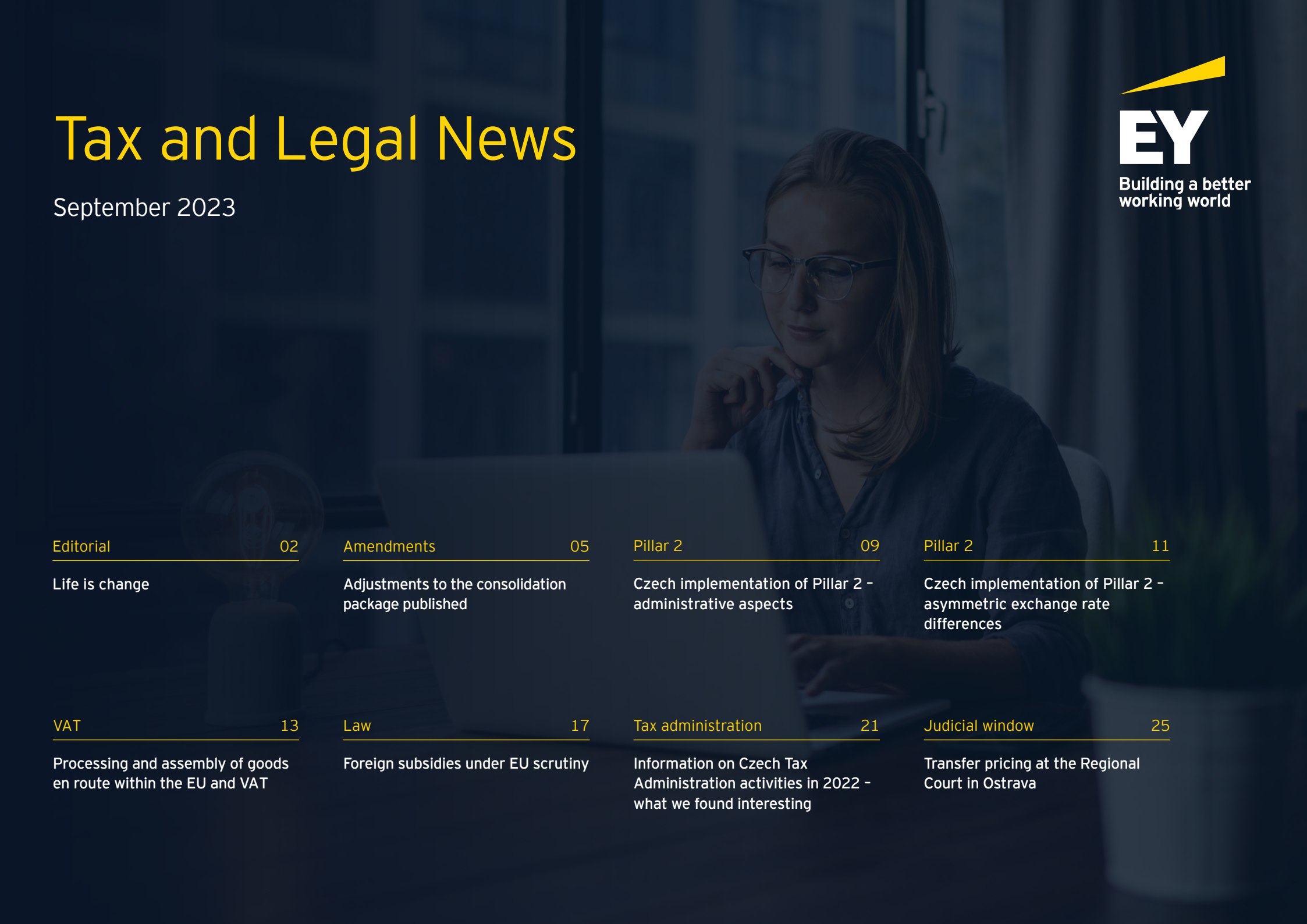

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Life is change

Some 500 years BC, the Greek pre-Socratic philosopher Heraclitus formulated the idea that the only certainty is change. We tax people like to counter with a slightly more modern quote from Benjamin Franklin in 1789: Nothing is certain except death and taxes.

Our government has now managed to neatly tie it all together for us. On the last day of August, it sent an amendment to the consolidation package to the Chamber of Deputies. In its concise amended version, without the explanatory memorandum, the parliamentary document with the amendments is 211 pages long (the explanatory memorandum on selected amendments to the Income Tax Act alone is 21 pages long).

The original government proposal of 30 June sparked a whole series of discussions, negotiations, led by trade unionists, entrepreneurs, beekeepers... And so (despite the initial traditional folklore of "nothing will really change this time") negotiations and amendments began.

Every proper tax amendment in our country has always had a major, popular, controversial flagship. Typically, it was meal vouchers. Nothing fiscally interesting, but socially pressing, with a strong lobby at its back. For this year's consolidation package, it was employee benefits (so far).

At first glance, it's a very simple and elegant change consisting in switching the benefits regime from exempt to taxable income, and now generally tax deductible. The motive was to unify the tax regime of ordinary wages and bonuses with the regime of benefits (and to prevent material bonuses from being translated into exempt benefits for children's school fees, above-standard health care, sports and cultural activities for the whole family, etc.). The result was complicated discussions about who and how much we tax when we rent out the gym for employees to play football every Thursday at 6:00 p.m.

In order to make the discussion thorough and complete, considerations around the tax treatment of so-called small snacks in the workplace (e.g. a bowl of fruit) were added. The related concept of "similar negligible benefits" is also introduced. The justification for the amendment then makes it clear in several lengthy paragraphs that refreshments are not income of the employee (however, they must not reach the size of a meal, i.e. they are not breakfast, lunch or dinner – if they do, the value of the meal is counted towards the exemption limit). I'm looking forward to the calculations of who ate what from the bowl and how extensive or insignificant it was for them. I hope no one ruins it for me with another amendment.

Just for the sake of completeness, when a business partner invites you to lunch, or you invite them, we have newly established that it should not be a taxable benefit for any of the participants, but the performance of work obligations.

As for benefits (real non-negligible benefits), the amendment works with a limit of 50% of the average wage (this would be a limit of CZK 20 162 for 2023). So I am also looking forward to the calculation and implementation of benefits in cafeterias, where companies currently provide employees with a limit of e.g. 25,000 per year.

Beekeepers fought back this year. The special provision on the amount of income from keeping bees for the purposes of the exemption was returned (with a slight reduction in the number of bee colonies from 60 to 50). Those of you who read the beekeepers' elaboration during the (this time very brief) comment procedure could not help but shed a tear. So a well-deserved win.

Then, out of the blue, we have the possibility to exclude unrealised exchange rate differences from taxation. A ground-breaking change. In addition, it will be left up to the taxpayer whether to opt for this regime or to stick with the current procedure. Calculations of the "advantage" of not taxing exchange rate gains but at the same time not deducting exchange rate losses will perhaps be even more interesting than the (in this light quite insignificant) benefits.

Another revolution is the introduction of a functional currency also for taxes (i.e. more as a proactive reaction to the amendment of the accounting regulations), but if the amendments in the currently proposed wording pass, there will be fewer exchange rate differences.

Behind the smokescreen of the above, a postponement of the abolition of the exemption for sales of companies (valued at over 40 million) until 2025 was subtly inserted into the amendment. So there will still be time for exempt sales. And the hunt for expert opinions as of 31 December 2023 is also postponed by a year.

We look forward to more amendments because our only certainty is change (and those taxes and death). Otherwise, we wish all you parents out there a happy start to the new school year.

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Amendments

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Adjustments to the consolidation package published

We keep you informed about the significant tax changes in the so-called consolidation package. The government coalition announced an agreement on the proposed modifications to the consolidation package and the text of the (very extensive) amendments proposed by the coalition parties was published.

Below is a brief summary of selected proposed changes compared to the originally presented text of the consolidation package.

Corporate income tax/accounting

Functional currency - A new option to keep accounting records in a currency other than the Czech currency is introduced through the new institution of the accounting currency, which may be the Czech currency, the euro, the US dollar or the British pound, provided that the euro, the US dollar or the British pound is also the so-called functional currency of the 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. The accounting currency of the accounting entity - the corporate taxpayer - was originally intended to be the same as the currency of the corporate income tax calculation. In the latest version of the amendments, this assumption is modified somewhat to take account of the technical possibilities of the tax administration system. Our understanding is that the general starting point for the latest set of these modifications is that, while it will not be possible to use foreign currency directly for the calculation of income tax, it will nevertheless be possible to use it in the defined sub-steps necessary for the calculation of income tax (i.e. the conversion of aggregate items).

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 generally include them in the tax base only in the period when the exchange rate difference is realised (notification to the tax administrator of entry into this regime is required).

Non-cash benefits - Expenditure on non-cash benefits to employees in the form referred to in section 25(1)(h) will not be tax deductible for the employer if they are also exempt for the employee under section 6(9)(d) (for the new exemption limitation see below).

Notification of income to non-residents - Compared to the original version of the proposal, the scope of income from sources within the Czech Republic to a non-resident taxpayer that the taxpayer is obliged to notify to the tax administrator has been expanded to include other types of so-

called capital income. At the same time, the simplified materiality limit for the exemption from the reporting obligation is restored for selected income.

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 so-called public CbC reporting - see HERE for further details. According to the transitional provisions, the income tax report is to be prepared for accounting periods beginning no earlier than 22 June 2024.

Sustainability report - The new Accounting Act introduces the obligation to prepare and make available a sustainability report. Due to the phased-in introduction in several stages, it is now proposed to impose this obligation (already for accounting periods commencing from 1 January 2024) only on an entity that cumulatively meets the following conditions - it is (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 number of 500 employees per accounting period as at the balance sheet date.

Personal income tax/employment tax

Employee Benefits - For defined tax benefits, an aggregate exemption limit (and therefore even for insurance premiums) of half of the average wage for the previous calendar year will be introduced. The original intention to remove the tax exemption for benefits altogether has been cancelled.

Employer-organized events - It is proposed to specifically provide that income derived from the participation of an employee (or family member) in a sporting or cultural event organized by the employer is 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 on a regular basis (e.g. weekly parties) and the criterion of reasonableness is not met by, for example, holding a Christmas party in an exotic destination or in other quite excessive circumstances.

According to the Explanatory Memorandum, because of this special exemption, employers will not have to keep track of which employee (and possibly his family member) attended the event and how much he consumed at the event in order to quantify his income from such an event, as the exemption applies to all such income without limitation as to the amount.

Postponement of the capping of the exemption of income from the transfer of securities - The consolidation package introduces a capping of the exemption of income from the transfer of shares in business corporations and securities from personal income tax to CZK 40,000,000 per tax year. The amendment proposes to postpone the effectiveness of this measure by one year (including the related possibility to "revalue" the acquisition value of shares and securities as of the end of 2024).

Repeal of the tax exemption for so-called executive apartments - According to a transitional provision, the repeal should not affect persons who resided in the apartments before the law comes into force.

Self-employment income - Persons with self-employment income will have an extended notofication obligation if the conditions are met and zero tax liability.

VAT/excise taxes

Newspapers, magazines and periodicals will be taxed at 12% VAT regardless of the frequency of publication.

Change in medical and diagnostic devices - 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 for the reduced rate. In addition, the verbal description of some items is being changed, for example, contact lenses, which have historically been the subject of controversy, will be explicitly listed.

Change in the gradual increase of excise duties on alcohol - The tax on alcohol is to be increased periodically in three steps, thus shortening the period to 3 years (2024-2026) from the proposed 4 years (2024-2027). The tax increase is to take place in a scheme of 10 + 10 + 5% (instead of the original proposal of 10 + 5 + 5 + 5%).

More moderate introduction of excise duty on alternative nicotine products - A 4-year gradual increase in taxation on alternative nicotine products is introduced, namely on e-cigarettes in the scheme of 2.5 + 5.0 + 7.5 + 10 CZK/1 ml of refill (instead of the originally planned increase to 10 CZK/1 ml); for nicotine sachets, in addition to the 4-year timetable, the target amount of the tax is reduced in a scheme of 0.4 + 0.8 + 1.2 +1.7 CZK/g (instead of the one-off increase to 3.45 CZK/g).

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

The government coalition announced an agreement on the proposed modifications to the consolidation package and the text of the (very extensive) amendments proposed by the coalition parties has been published.

Pillar 2

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Czech implementation of Pillar 2 – administrative aspects

Recently, an updated draft of the Czech implementation of the Pillar 2 rules was published, i.e. a draft law on top-up taxes for large groups. The proposal has already been submitted to the Chamber of Deputies for approval (more in Czech HERE) and the legislative process is likely to be relatively quick.

Below we bring you updated selected observations on related administrative aspects:

- The taxpayer of the top-up tax (TT), both Czech domestic and assigned (i.e. according to the IIR/UTPR rules), is generally the Czech constituent entity of a large group and the foreign constituent entity of a large group with a Czech permanent establishment.
- The taxable period is generally the accounting period of the ultimate parent entity for consolidation purposes.
- The administrator of the TT is generally the Specialised Tax Office.
- A TT taxpayer established in a non-Member State must choose an agent for correspondence established in a Member State.
- There will be an exclusively electronic form of submission.
- The return for the Czech TT should be submitted within 10 months, while the return for the assigned TT should be submitted within 22 months (the deadline cannot be extended).
- The Czech TT information return should be submitted within the deadline for the Czech TT return (i.e. 10 months); the deadline cannot be extended. This factsheet may be filed by another Czech TT taxpayer from the same group, provided it has the same content and is filed within the deadline (however, this must be notified to the TT administrator).
- The assigned TT information return should be submitted within 15 months (18 months for the first period); the deadline cannot be extended. This information return may be submitted by the ultimate parent (or designated) entity in the qualifying State, provided that it has identical content and is submitted within the deadline (but this must be notified to the TT administrator).

- The details of the information return will be described in the implementing regulation.
- Self-assessment mode is applied.
- The proposal contains its own statute limitation (and collection) rules for the Czech TT. In general, the limitation period will be 4 periods after the period of due date (the period does not run during the related court proceedings).
- The fine for failure to comply with an obligation of a non-monetary nature will be up to CZK 1.5 million.

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

The return for the Czech top-up tax should be filed within 10 months, while the return for the assigned top-up tax should be filed within 22 months (the deadline cannot be extended).

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Czech implementation of Pillar 2 – asymmetric exchange rate differences

The projected effective date of the draft law on top-up taxes for large groups (TT) is 31 December 2023 (more in Czech HERE), and therefore companies should already calculate the potential impact of Pillar 2 (e.g. for audit purposes).

Here is our current understanding of the adjustment to accounting profit for asymmetric foreign exchange (FX) differences. Our understanding of the rules is that there are three situations (imagine a functional currency of CZK for tax and EUR for GloBE financial statements):

- FX included in the tax result but not in the accounting result (e.g. EUR receivable) – in this case we should adjust the accounting profit for GloBE purposes to match the recognition for tax purposes.
- FX included in accounting profit but not in tax profit (e.g. CZK receivable) – again, we should adjust accounting profit for GloBE purposes to match recognition for tax purposes.
- FX in relation to a third currency (e.g. USD receivable) – in this case we should make two adjustments:
  - exclude FX included in accounting profit (for GloBE purposes);
  - FX between the currency (USD) and the currency for tax purposes (CZK) is included, regardless of whether this FX is included or excluded from the tax base under the tax rules.

We will provide you with more interesting insights next time.

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

The adjustment of accounting profit for asymmetric exchange differences distinguishes four types of differences.

VAT

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Processing and assembly of goods en route within the EU and VAT

In practice, we often deal with enquiries from clients about how VAT is applied to cross-border supplies of goods where the goods are processed or otherwise finished before or after crossing the border (i.e. not just logistical stopovers). The result of such transactions is that the goods leave the supplier in a different form than they arrive at the customer. The answer to this question is not always straightforward because different contractual arrangements between the supplier and the customer, as well as arrangements with the processor, can lead to different VAT conclusions.

The VAT Directive and the Czech VAT Act provide for the situation where goods are transferred to another Member State for the purpose of processing and then returned "home". In such cases, an exception can be relied upon and the transfer of the own property not reported. Any more complex journey of goods for reprocessing already carries tax and administrative risks. For the supplier, this may mean not meeting the conditions for exempt supplies to the EU and/or having to register in the customer's country due to the relocation of its own assets. The customer may run the risk of having to register in the supplier's country or not being able to deduct input tax on local purchases.

Below we summarise the general principles and available interpretations on this issue. This is primarily to remind companies to take any processing along the way as a signal for a more thorough tax examination. To reach the right conclusion, it is often enough to answer two basic questions: *"What goods has the supplier committed to deliver?"* and *"Who is ordering the processing service?"*. The answers to these questions, combined with the knowledge of where the goods are processed and who provides the transport, should lead to the right solution.

Available interpretations

- Historically, the interpretation of this topic was dealt with in a paper at the KDPČR (Czech Chamber of Tax Advisors) Coordination Committee 636/20.10.04 – Tax regime for the supply of goods to another EU Member State. It is important to draw attention to this paper precisely because it is no longer valid. In the paper in question, a Czech company supplied goods to an EU customer. The customer also ordered processing work from another Czech payer. Thus, before

crossing the Czech border, the product was altered and goods other than those invoiced by the supplier left the Czech Republic. The Ministry of Finance has accepted the submitters' proposal that such deliveries to the EU, where transport is temporarily interrupted for the purpose of processing work in the Czech Republic ordered on behalf of the customer, may be exempt under § 64 of the VAT Act (subject to other conditions). That interpretation is almost 20 years old and, in light of the more recent case law of the Court of Justice of the EU ("CJEU"), can no longer be relied upon.

- Judgment C-446/13 – Fonderie 2A dealt with the supply of goods between an Italian and a French company. The goods left Italy in their original condition, but were painted in France before being delivered to the French customer. This work was ordered by the Italian supplier. Here, the CJEU expressed a fundamental idea, namely that the transport of goods generally begins when the product is in the form agreed between the contracting parties. In this case, the sale was of lacquered products and therefore such goods could not have been delivered earlier than in France. This means that the Italian supplier first moved its own goods to France in order to subsequently complete and deliver them without (cross-border) transport.

- In Judgment C-606/12 Dresser Rand SA, the CJEU dealt with the sale of goods from a French supplier to a Spanish customer. The assembly of the product took place in Italy, where components were transported from various countries (EU and non-EU). The final product then went on to the customer in Spain. This case would also lead to the registration of the French supplier in the country of assembly due to the transfer of its own goods. In fact, the CJEU stated that any exceptions to the rules on the transfer of own property must be interpreted strictly, and in this case the condition that the goods are returned to the country of origin after processing was not met.

- The topic of processing en route was also partly addressed in Judgment C-386/16 Toridas UAB, where frozen fish was shipped between three companies from three different EU countries. Before the goods left the first state, they were sorted, packed and glazed on behalf of the middle company. Transportation was also handled by the middle company. The judgment was primarily concerned with the allocation of transport to the first or second delivery. From the circumstances of the case, the CJEU concluded that the transport must be attributed to the second delivery and the processing of the goods does not affect this fact. The condition of transport to the EU was not met for the first supply to be exempt from VAT. According to the CJEU, the processing took place after the first supply and therefore has no bearing on its assessment.

- A slightly more positive conclusion was published some time ago by the European platform EU VAT Forum in its VAT Cross Border Rulings – CBR. Although it is not a legally binding opinion, it can be used as a kind of guide to the interpretation of European rules. The Platform addressed the possibility of exempting the supply of tires to another Member State when these tires do not leave the country in their original form but are first transported to the car manufacturer's plant in the same country and mounted on vehicle bodies that the customer has also bought. According to the conclusions of this platform, the supply of tires can be exempted from VAT if the supplier of the tires provides reliable evidence of transport to the EU and also provides proper contractual documentation of the use of the tires on the vehicle body. This case differs from the others in that the customer buys two different products from two different suppliers (vehicle bodies and tires) and not a processing service.

For any sale of goods, the allocation of transport is essential. In simple terms, the processing of the goods en route results in a break in the transport (i.e. the transport of the product in its original form has ended) and potentially begins the onward transport of the new product after processing. Another common feature of all this completion and processing work en route is that the billing flow is different from the physical flow of goods. In all such cases, companies should take care to think about setting up the business model in advance.

Often the situation can be saved by having the customer order the processing service instead of the supplier, or vice versa, and this is reflected in the price of the product. Another option is to order processing in another country, depending on other circumstances. However, the alternative setup often cannot be sought retrospectively when the business is already running. Therefore, we encourage our clients to contact our team early to avoid tax inefficiencies and administrative burdens.

In the future, the problem of relocation of own assets to the EU should be resolved under the so-called ViDA amendment, which plans to introduce a single European VAT registration from 2025 and allow reporting of the relocation of goods in the One-Stop-Shop system.

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

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Foreign subsidies under EU scrutiny

An EU regulation affecting M&A transactions and public procurement is gradually coming into force.

As of 12 January 2023, the EU's internal market protection has extended to foreign subsidies. Regulation on the control of foreign subsidies ("the Regulation"), on which we already reported in Tax News, is gradually coming into effect. Its main objective is to prevent the EU internal market from being influenced by foreign subsidies, which according to EU legislators have had a significant, often negative, impact in recent years. In today's article, we look in particular at the possibilities of control by the European Commission and the new obligations that businesses must prepare for and will soon have to start complying with.

Checks by the European Commission

The Regulation brings together three sets of tools that the EU authorities will have at their disposal to protect the internal market. The first of these packages, which came into effectiveness on 12 July 2023, provides the European Commission ("the Commission") with the ability to carry out ex officio inspections known as in-*depth investigations*. These investigations may be initiated on the basis of information from any source. The Regulation lists as specific sources natural or legal persons or associations thereof, but also Member States themselves. Prior to the investigation itself, the Commission will initiate a *preliminary examination* to determine whether or not the case involves a foreign subsidy. The subsidy may take the form of a grant, a loan, debt relief or the supply or purchase of goods or services. It may be granted by third countries as well as by private entities controlled by those countries. At this stage, the Commission may already request any information it deems necessary.

Where the Commission is satisfied that a foreign subsidy endangering the internal market has been granted, it shall initiate an in-depth investigation and inform the undertaking under investigation of the initiation of the investigation. The Commission shall further inform the Member States and publish the decision to open an investigation in the Official Journal of the EU. It will also invite the parties to submit written comments. The Commission has powers in these investigations which it also has in other internal market control matters. These include the possibility to request information from the undertaking under investigation, to carry out local investigations by Commission officials not only within the EU but also, after being informed, in a third country. In addition, it may impose interim measures to prevent irreparable harm to the internal market, impose fines and penalties, remedies or commitments to avoid internal market effects by the undertakings concerned. The time limit for the decision is 18 months from the initiation of the investigation. In terms of the temporal scope of the Regulation, the Commission may review such foreign subsidies granted during the five years prior to 12 July 2023 if they continue to distort the EU internal market after that date.

Notification obligations for mergers

The second and third packages will come into effect on 12 October 2023 and will introduce a so-called notification obligation for companies conducting an M&A transaction and public procurers (including public contracting authorities). These entities will now have to notify the Commission of foreign financial contributions received in situations anticipated by the Regulation. We will now focus on the second package, namely the notification obligation for mergers.

Businesses will now have to be wary of M&A transactions and determine whether one or more companies involved in the transaction have received financial contributions from a foreign state. Notifications will have to be made where (i) one of the undertakings concerned, the target undertaking or the resulting joint venture is established in the Union and has a total turnover of at least EUR 500 million and (ii) in the three years preceding the conclusion of the agreement, the announcement of the bid or the acquisition of a controlling interest, the merging undertakings have received in aggregate financial contributions from third countries amounting to EUR 50 million. This limit applies to all merging entities – this includes, inter alia, undertakings which are directly or indirectly owned or where the merging entity has the power to direct the affairs of those undertakings. It should be stressed once again that the supply or purchase of goods and services is also considered to be a financial contribution. The complexity and costliness of M&A transactions will be considerably increased by the need to carry out very thorough verification of all financial contributions made by third countries. Tracking back and assessing all the financial contributions received can be very challenging and not very reliable. Businesses are therefore likely to have no choice but to create and maintain records of these contributions.

If the undertakings carrying out the transaction conclude that they fall within the scope of the Regulation, they shall notify the Commission. In such a case, the merger may not be implemented before notification and the Commission's decision will thus necessarily constitute a condition precedent to the legal effectiveness of the merger in the given M&A transactions. After notification, the Commission may conduct a preliminary review and an in-depth investigation. The Commission has powers in this case similar to those in situations where it acts ex officio, except for the power to impose fines and penalties or remedies. Three different situations may follow the submission of a notification:

- the Commission receives a complete notification and does not decide within 25 working days from the date of receipt of the notification -> the merger can take place;
- the Commission receives a full notification and opens an in-depth investigation within 25 working days -> the merger can be implemented after 90 working days from the date of the opening of the in-depth investigation, or 105 working days if the undertakings offer commitments to remedy the distortion of the internal market;
- The Commission adopts a commitment decision before the expiry of the time limit or does not object -> the merger may be implemented subject to the conditions set out, if they exist.

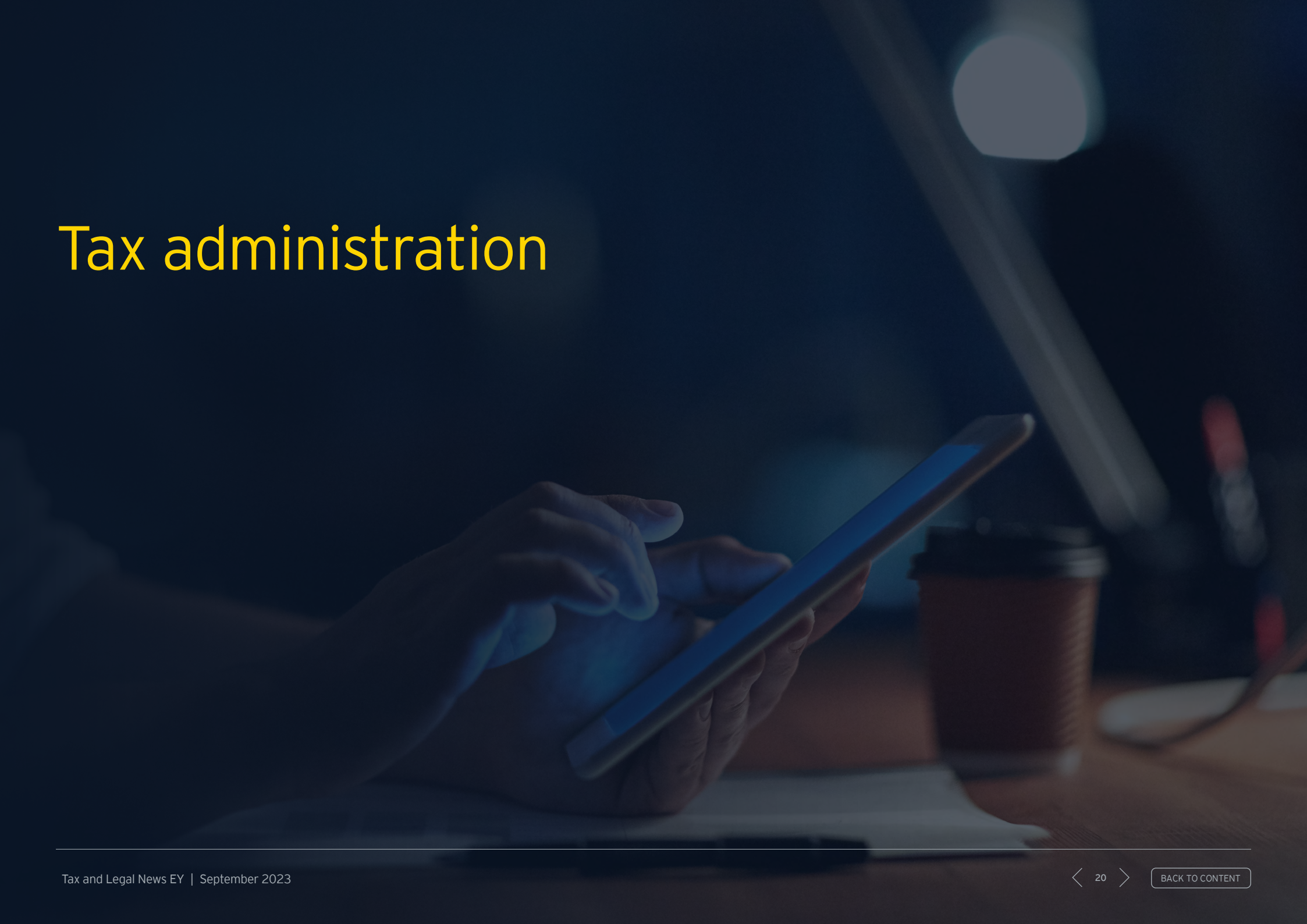
Where undertakings fail to notify a merger subject to this obligation or attempt to circumvent the Regulation, the Commission may impose a fine of up to 10 % of the total turnover of the undertaking concerned in the preceding financial year, even if the undertakings acted negligently. The provision of incorrect or misleading information may also be sanctioned up to a maximum of 1% of the total turnover of the undertaking concerned in the preceding financial year.

Finally, it should be noted that in the event of a notification of a merger or notification in the context of a tender procedure, foreign financial contributions made in the three years prior to 12 July 2023 will be considered.

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

Where undertakings fail to report a merger subject to this obligation or attempt to circumvent the Regulation, the Commission may impose a fine of up to 10 % of the total turnover of the undertaking concerned in the preceding financial year, even if the undertakings acted negligently. The provision of incorrect or misleading information may also be sanctioned up to a maximum of 1% of the total turnover of the undertaking concerned in the preceding financial year.

Tax administration



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Information on Czech Tax Administration activities in 2022 – what we found interesting

Every year, the Tax Administration (TA) publishes a report on its activities, which comments not only on tax collection, but also on inspection activities, international cooperation in the field of taxation and the exercise of other competences. Below we summarise what we found to be of interest.

Tax collection

- The total tax collection for 2022 amounted to CZK 1,002.9 billion, a significant year-on-year increase of 15.8%. This was the first time since 2019 that total annual tax collections exceeded CZK 906 billion. The increase in collections was mainly driven by the economic recovery in the first half of the year and largely by inflationary price increases.
- VAT collections increased by 15.6%. The most significant increase in collections was recorded by the Specialised Tax Office, at 28.8%. On the other hand, the Moravian-Silesian Region recorded the largest decrease in VAT collection due to the increase in the level of excessive deductions by non-established persons with a focus on production, mainly abroad.
- Total CIT (corporate income tax) collection rose from CZK 200 billion to CZK 228.7 billion. The recovery of the economy and the end of the impact of the previously adopted measures (the so-called "general pardons") contributed significantly to the increase in collections. In the light of the macroeconomic changes marked by the global crisis triggered by the spread of the COVID-19 pandemic, the Financial Administration considers 2022 to be a successful year in terms of the development of CIT collections. At the same time, the Tax Administration warns of the impact of the emergency situation in Ukraine on the collection of CIT on returns, which will only become apparent in the following years.

Inspection activity

- The number of completed procedures for the removal of doubts (PRDs) in the field of VAT in 2022 has again decreased, this time by 20.9% compared to 2021, i.e. to an absolute value of 5.7 thousand. The likelihood of a PRD ending with a change in tax liability decreased

by 26.6% compared to the previous period. These results can be attributed to the impact of restrictive pandemic measures in previous years. According to the Tax Administration, a downward trend in the number of completed PRDs can be expected in the future as well, due to the possibility of initiating tax audits by correspondence based on the Tax Code amendment effective from 2021.

- Compared to 2021, there will be a significant increase in the number of completed tax audits in 2022, from around 6.5 thousand to almost 9.7 thousand. On the basis of these tax audits, approximately CZK 6.7 billion was assessed. In the past, the TA has attributed the low number of tax inspections to the impact of the COVID-19 pandemic, e.g. delays in meetings due to isolation and quarantines or longer waiting times for processing responses in the framework of the international exchange of information.

- The most frequent findings were in the area of claiming a deduction for fictitious transactions, non-recognition of taxable transactions and abuse of law in the issue of crown bonds.

- The TA focused on corporate income tax inspections in 2022 on income tax withheld at a special rate (i.e. mainly on crown bonds). The number of these audits increased by 76.1% year-on-year, with an increase in the tax assessed of just under CZK 140.1 million.

Other

- The collection of the road tax, which is a revenue of the State Fund for Transport Infrastructure, fell by almost CZK 3.7 billion year-on-year, which in relative terms corresponds to approximately 68.1%. According to the TA, the drop was caused by the adoption of Act No. 142/2022 Coll., which amended the Road Tax Act with retroactive effect from 1 January 2022 and narrowed the scope of the tax and reduced the tax on taxable vehicles.

- According to the data provided by the TA, there has been a significant year-on-year increase in the collection of the solar electricity levy of around CZK 2.9 billion. The total amount of the solar electricity levy thus amounted to over CZK 5 billion. According to the TA, a significant share of this increase should be due to the amendment of Act No. 165/2012 Coll. with effect from 1 January 2022. The amendment to this Act extends the subject of the tax to equipment put into operation in 2009, which is now subject to levies of 10% (for the purchase price) and 11% (for the green electricity bonus). The levy was increased to 20% and 11% for the 2010 installations. Other factors affecting the collection rate include the weather in a given year. Fluctuations in power generation due to adverse weather can be as much as +/- 20%.. Compared to 2021, there is an increase of 145 hours of sunshine in 2022. At the same time, the feed-in tariff for solar electricity for installations commissioned in 2010 increased by 302 CZK/MWh and the green bonus price decreased by 73 CZK/MWh.

- Compared to 2021, there will be a significant increase in gambling tax revenue in 2022 by more than CZK 5.4 billion, which in relative terms represents an increase of almost 50%. In previous years, the gambling market faced restrictions in the wake of the COVID-19 pandemic. As a result of these restrictions, some operators were forced to close their premises, particularly live and technical gaming operators in brick-and-mortar establishments. According to the TA, income growth could be driven by rising living standards and salary increases across sectors. At the same time, the TA estimates an increase in the share of online gambling revenue in total gambling revenue in the future, despite the preference of some players to visit brick-and-mortar establishments.

Cooperation with law enforcement agencies

Thanks to the Cooperation, Exchange of Information and Coordination Agreement (COBRA cooperation), around CZK 1.2 billion in public revenue was saved in 2022. Of this, CZK 607.7 million was secured and CZK 596.8

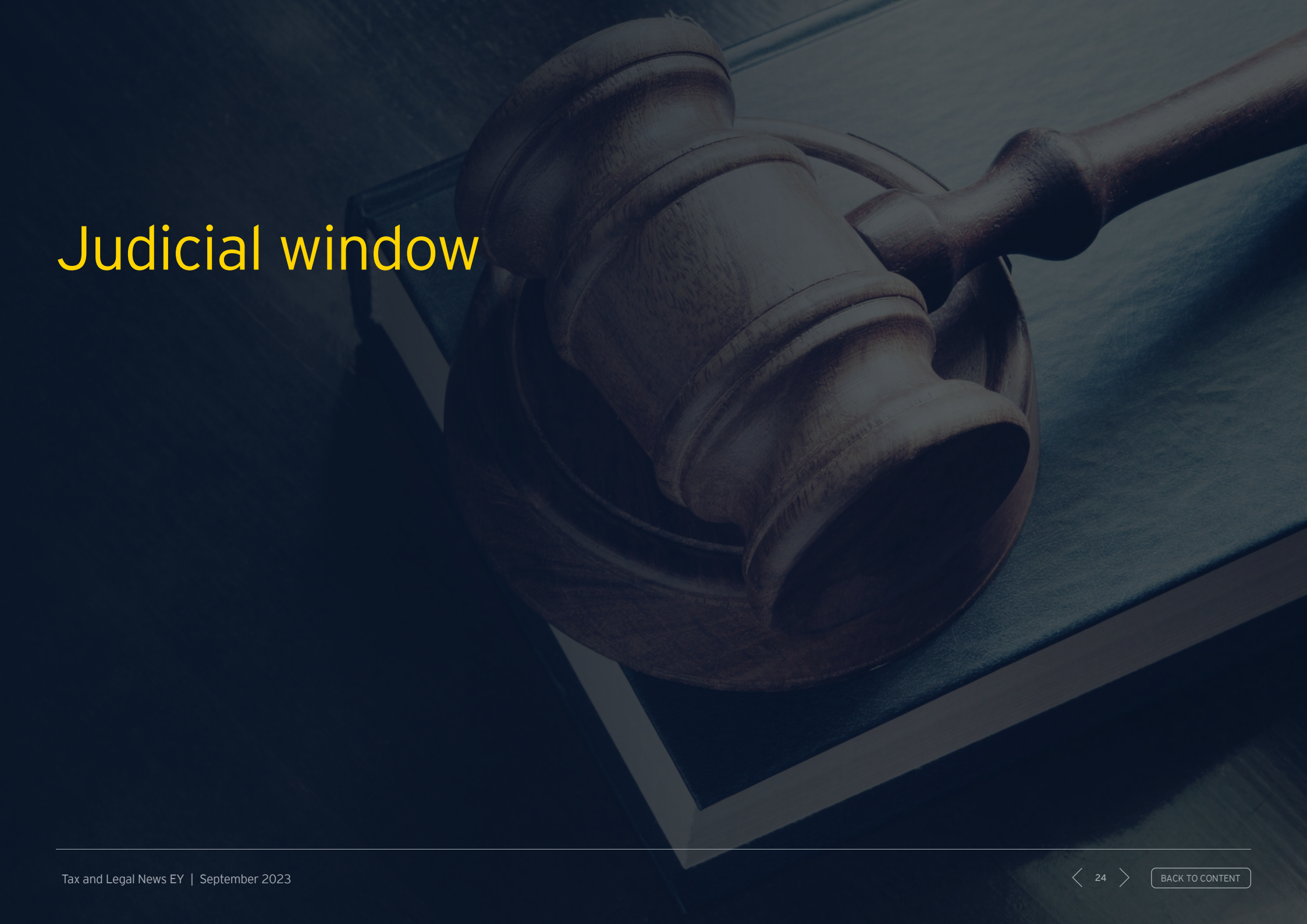
million was saved under the central and regional COBRA. However, the TA warns that it is essential to find ways to eliminate the risks and damage related to tax collection. The TA estimates that the damage caused with regard to VAT alone is in the tens of billions per year. The TA has published several cases resulting from cooperation with law enforcement authorities. Below we select some of them.

- **False accounting records** – An organised group was accused of illegal tax optimisation of five companies. The group produced false accounting documents which were included in value added tax returns and control reports. The estimated damage was around CZK 44 million.
- **Fake tax documents for advertising services and IT work** – In 2022, a case was handed over to the prosecutor's office, resulting in the indictment of 11 individuals and 3 legal entities. The persons were alleged to have committed the crime by creating fake tax documents for a group of interested parties in return for a commission, which enabled the alleged customers to reduce the tax. Among the fictitious transactions were mainly agency employment or advertising services, as well as IT work. The amount of damage in this case was estimated at CZK 264 million.
- **The OCTAVIAN case** – In 2022, an investigation into tax evasion and laundering of the proceeds of crime was concluded with damages of around CZK 700 million. Detectives from the National Criminal Police and Investigation Service's National Centre against Organised Crime (NCOZ) uncovered a sophisticated structure in which money was laundered from excessive VAT deductions in companies controlled by the accused. These funds ended up in numerous transactions in the bank accounts of off-shore companies. The total damage caused to the Czech Republic amounted to around CZK 700 million. The NCOZ officers managed to seize assets in the full amount of the damage caused as so-called replacement property.

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

The most frequent findings were in the area of claiming a deduction for fictitious transactions, non-recognition of taxable transactions and abuse of law in the issue of crown bonds.

Judicial window



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Transfer pricing at the Regional Court in Ostrava

The Regional Court in Ostrava recently published a judgment[1] in which it commented on several interesting aspects of the issue of transfer pricing. As we believe that the court's conclusions may have a more general application, we provide below a brief summary of the case.

Background

The taxpayer's activity consisted of the production of semi-finished goods which it supplied to its parent company. The parent company continued to process the semi-finished product and subsequently sold it to end customers. The selling price of the semi-finished product was determined using the resale method based on the price at which the finished product is sold to the final customer. This price was reduced by the agreed gross margin of the parent company for the purpose of determining the selling price between the Czech company and the parent company.

Tax proceedings

Although the taxpayer in the tax proceedings repeatedly pointed out to the tax administrator, in particular, the simplistic evaluation of the functional profiles of both companies, but also other shortcomings, the tax administrator concluded that the profitability of the parent company was too high in the relationship. It attributed the excessive income to the Czech company and assessed the corresponding tax.

Statement of objection

The taxpayer raised several objections in its application, which the Regional Court dealt with successively:

- Failure to take into account the more complex functional and risk profile of the parent company;
- Comparison of the margin achieved by the parent company from the tested transaction only versus the net operating margin of comparable entities for the company as a whole;
- Incorrect exclusion of certain entities from the sample of comparable companies;

1 Judgment of the Regional Court in Ostrava – Olomouc Branch dated 11 April 2022, ref. No. 65 Af 37/2020-85, available in Czech here.

- Unjustified narrowing of profitability margins by the interquartile range method.

View of the Regional Court

1. Evaluation of the functional and risk profile

- In practice, many production and distribution entities can be found whose typology of functional and risk profiles will not conform to precise boundaries. In its judgment, the Regional Court emphasised that all non-typical cases (such as the present case) must be assessed individually in the light of the specific characteristics.

- In the present case, it was necessary to analyse the activities of the two companies of the tested transaction, taking into account their combined production-distribution functional profile. If that analysis had been properly carried out, the tax authorities could not have reached the simplistic conclusion that the parent company in the chain was merely a distributor. This is particularly so in view of the scale of the production activities and the associated risks borne by the parent company.

- The level of risks generated by own production activities compared to the risks resulting from the mere purchase from a supplier is unquestionably higher and should logically be compensated by higher expected profits.

- However, the Regional Court did not find in the contested decision an analysis of the activities of both parties to the tested transaction and an assessment of the extent to which both parties participate in the production of the final product, nor a related revision of the conclusion whether it is appropriate to compare the parent company only with the distributors.

2. Profitability within the transaction vs. profitability of the company as a whole

- The tax administrator subjected the profit margin achieved by the parent company on the tested transaction to a comparative analysis, whereas for comparable entities it based its analysis on the net operating margin of the company as a whole.

- The taxpayer's objection relating to the asymmetric comparison of profitability was not reflected in the proceedings by the tax authorities, although, according to the Regional Court, it is a perfectly valid argument. For this reason, the Regional Court found that the contested decision was partially unreviewable.

3. Comparator independence index

- Another complaint was directed against the tax administrator's procedure for determining the sample of comparable entities. The tax administrator excluded from the sample several entities whose possible inclusion would have considerably widened the profitability margin. Having found that some entities achieve a lower independence index (B+)[2], the tax administrator subjected them to a more detailed analysis. These entities were then excluded from the sample, not because of doubts about their independence, but because of their allegedly inadequate functional and risk profile. The appellate body then refused to take these entities into account in its decision precisely because the criterion of independence was not met.

2 These are entities with 6 or more owners whose total shareholding in the company exceeds 75%, with at least one owner holding more than 25%, but not more than 50%.

- The Regional Court pointed out, in line with the taxpayer's objection, that such a conclusion was contrary to the content of the administrative file. The defendant cannot claim that, like the tax administrator, it considered the B+ independence index alone to be a sufficient reason for not including the companies concerned among the comparators, since the tax administrator did not follow such a strict and formalistic approach.

4. Application of the interquartile range method

- The last objection was directed against the application of the statistical method of the so-called interquartile range to the established profitability of comparable entities.

- The Regional Court acknowledges that this method is generally a perfectly valid tool for possible mathematical refinement of the results of statistical data, but at the same time it does not automatically lead to an increase in the reliability of the comparative analysis of transfer prices. Its use must always be considered on a case-by-case basis, taking into account the specific parameters of the case.

- According to the Regional Court, in the present case the sample of comparable entities was relatively small (14), the range of values found was not necessarily wide (7 p.p.) and the range of values found was continuous. It was for the tax authorities to correctly justify the narrowing of the full profit margin by any outliers and to demonstrate that the method they had chosen actually led to an increase in the reliability of the calculated result.

- The Regional Court also noted that the tax administrator is always obliged to properly justify its own procedure. This is not affected by the fact that the taxpayer itself used the interquartile range method in the proceedings. Moreover, the taxpayer used the method in a different context – it was data corresponding to a broader sample of entities, with profit margins in the tens of percentages, and it did not perform as detailed an analysis of the comparability of the entities as the taxpayer's own sample.

Conclusion

The Regional Court therefore annulled the contested decision in the present case and remanded the case back to the tax authorities. The position of the Regional Court can be clearly perceived as an appeal to the tax administrator not to slip into automatic use of general procedures and methods in the issue of transfer pricing, where the burden of proof specifically weighs on it, without paying sufficient attention to the specifics of individual cases and proper justification of its actions and conclusions. This was also confirmed by the Supreme Administrative Court in the meantime[3] (we informed you in more detail here).

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3 See the judgment of the Supreme Administrative Court of 19 December 2022, ref. No. 2 Afs 66/2021 – 51.

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

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ED None

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Did you know:

- There has been an interesting development regarding the deductibility of VAT of services received by a holding company in connection with the sale of a shareholding in a controlled company?
- The Office for the Protection of Competition issued an interpretation on shortening the deadline for filing objections in procurement proceedings?
- An amendment is reportedly in the works to make employee shares more attractive?
- EY is holding a webinar on employee issues?