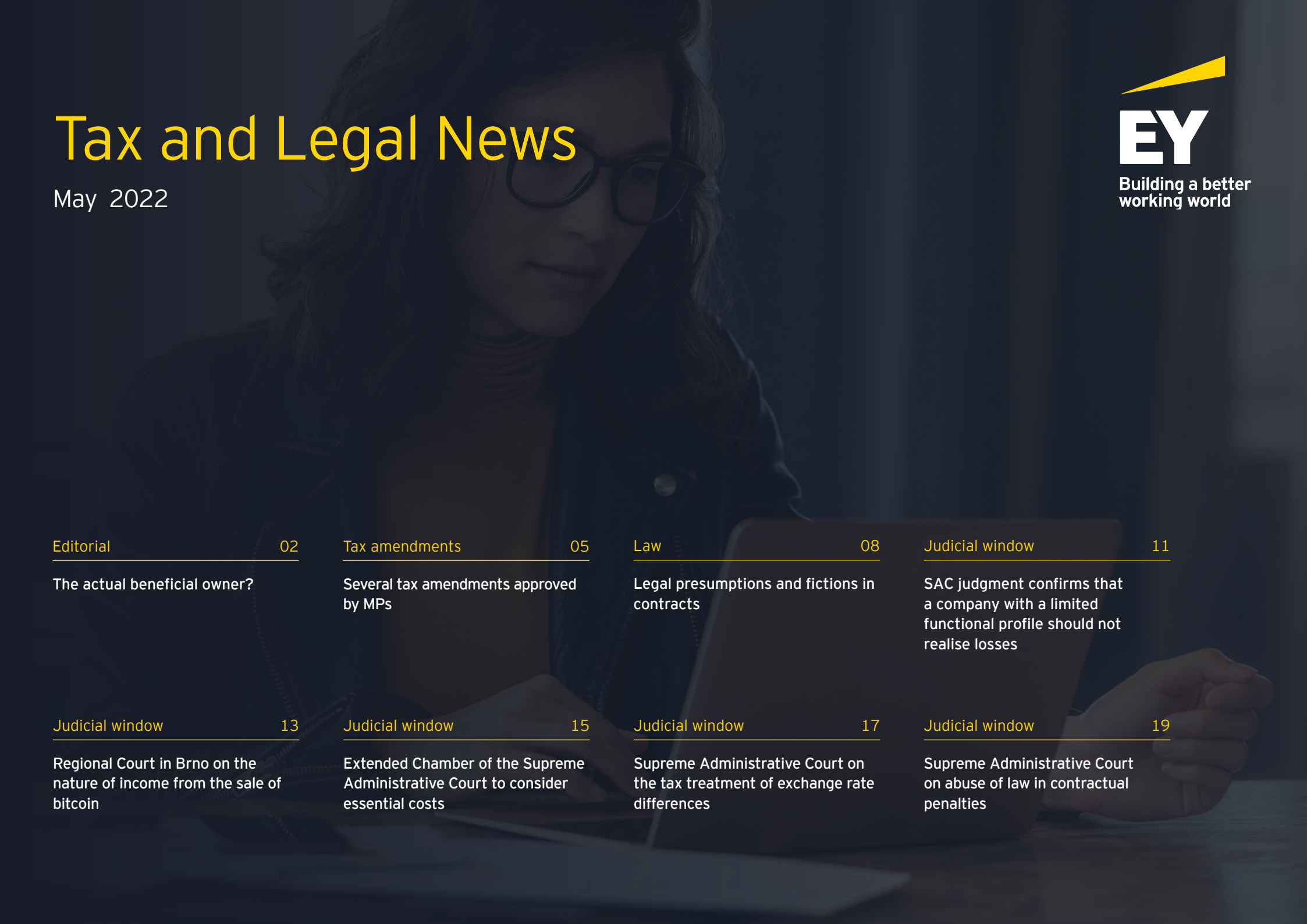
Tax and Legal News

May 2022



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The actual beneficial owner?

Last July, I chose the topic of beneficial ownership registration for my editorial and conceived it as an expression of support for corporate lawyers in their struggle to identify the beneficial owner within the branching corporate structures of their companies. If I return now to the topic of this still relatively new registration obligation, I risk giving readers the impression that with the passing years, I'm coming to show a tell-tale sign of aging, i.e. the inability to give up an idea.

So, in my defence, I'd like to start by explaining that I'm returning to the subject of beneficial ownership registration after almost a year for two good reasons. The first is that even after almost 12 months of the new law coming into effect, this topic still resonates strongly among our clients, raising a lot of questions. At least once a week, we find ourselves explaining, especially to our numerous foreign clients, how the Czech legislator actually meant the definition of beneficial owner and whether it's really necessary to provide copies of several personal ID cards of the highest owner for registration purposes, or whether Jeff Bezos should really have his address registered in the Czech register of beneficial owners. The second reason is the planned amendment to the Act on the Registration of Beneficial Owners, in which the Czech legislator plans to respond to the European Commission's criticism of poor European AML Directive implementation.

In the case of large international groups, with our clients we most often deal with the registration of a so-called substitute beneficial owner, i.e. a situation where a specific natural person at the top of the corporate pyramid who would meet the definition of a beneficial owner under Czech regulations cannot be identified, i.e. was either the final beneficiary of profits generated by the group or directly or indirectly controlled the group. As we said last July, a significant change brought about by the new Czech Act on the Registration of Beneficial Owners in the case of a substitute owner was that the substitute beneficial owner of a Czech company can no longer be considered its statutory body. Under the new definition of a substitute UBO (ultimate beneficial owner), members of the statutory body of a legal entity that is the highest ranking entity in the group pyramid should be registered in the Czech register.

This change has raised and continues to raise a lot of practical questions from clients. Should all members of the "board" controlling US joint-stock companies, but who have no idea about the functioning of their Czech LLC, be registered as substitute beneficial owners of the Czech LLC? Or would the definition of indirect control be better suited to the registration

of only one specific director (even in a B-1 position) who also oversees the activities of the Czech subsidiary? If there is indeed a "Director for Europe" who can exercise influence over a Czech company through a chain of controlling companies, then the definition of a substitute UBO is met. What is important, of course, is the actual performance of, or the real possibility of exercising, actual influence; it should not be an artificial selection of a single member of the board of the parent company who was persuaded by colleagues to be entered in a special register somewhere in the Czech Republic.

From these few practical observations, it's clear the current Czech regulation of the registration of beneficial owners is far from perfect. The European Commission has also noticed this, criticizing the Czech legislator in its comments, in particular for defining beneficial owner too broadly. There's some truth in this remark, especially if we remember that the Czech regulation actually distinguishes two independent characteristics of the beneficial owner. The beneficial owner may be recorded as either the ultimate recipient of a property benefit from the group (e.g. profit or liquidation surplus) or an individual exercising, directly or indirectly, decisive influence over a group of companies.

According to the explanatory memorandum, the forthcoming amendment to the Act on the Registration of Beneficial Owners responds to the comments of the European Commission and one of its objectives should be to narrow or refine the content of the definition of a beneficial owner. The amendment thus deletes the aforementioned categories of "final recipient of benefit" and "person with ultimate influence" and will now examine whether the individual meets any of the criteria defining a beneficial owner. If the answer is yes, the basis for the registration will be given and it will therefore be unnecessary to distinguish whether a beneficial or an influential UBO is being registered.

However, the amendment also modifies the shareholding thresholds for the assessment of indirect control, which effectively expands the number of persons who can be considered beneficial owners and thus compulsorily registered in the Czech register of beneficial owners. Under the amendment, in order to meet the definition of a UBO, it is sufficient for an individual to control a corporation that has a shareholding in the registrant in excess of 25%, and there is no need to further examine whether such a shareholding actually enables the exercise of decisive influence, as is the case under current law. Therefore, if the amendment were passed as currently worded, many business groups would realistically be at risk of having to register additional persons who originally failed the indirect influence test.

The amendment is currently being widely commented on and we can therefore expect the legal text to be subject to further changes during the legislative process. However, if the proposed amended definition of beneficial owner were to remain in the amendment, it would be necessary to review the group structure and possibly add additional persons to the register who would meet the newly defined concept of beneficial owner in order for companies to avoid the risk of sanctions (e.g. a ban on voting at the general meeting or a ban on dividend payments). In conclusion, I regret to say that in the Czech legal environment, we still can't be sure if someone is an actual beneficial owner.

The European Commission does not like the Czech regulation on the registration of beneficial owners. However, it is questionable whether implementing the planned changes would improve the situation.

Tax amendments

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Several tax amendments approved by MPs

The Chamber of Deputies approved several tax amendments in April.

Rising fuel prices

The first package of amendments (Parliamentary Documents 204 and 205) contains measures primarily responding to rising fuel prices.

Income tax

In the case of low-emission motor vehicles, the amendment reduces the percentage of the input price that is treated as income of the employee for the purposes of the Income Tax Act in relation to the free-of-charge provision of a motor vehicle by the employer for business and private purposes from 1% to 0.5% of the input price of the low-emission motor vehicle. If approved, this should already apply to the entire 2022 tax year.

Furthermore, items of equipment used exclusively to recharge electric vehicles with an electric drive or a drive combining an internal combustion engine and an electric motor listed in the CZ CPA classification under 27.11.50 and 27.12 (i.e. both conventional recharging stations and so-called wallboxes) are reclassified from depreciation group 3 to depreciation group 2. For assets already acquired (i.e. assets acquired before the amendment's effective date), the taxpayer should be given a choice between the existing and new treatments.

More [in Czech] HERE.

Excise duty on gasoline and diesel

Excise duty on diesel and unleaded gas is temporarily reduced by CZK 1.50 per litre from 1 June 2022 to 30 September 2022 (more [in Czech] HERE). This was later approved by the Senate.

Road tax

In addition to the abolition of road tax in the under 12 tonne category, there should also be a reduction in the rates for trucks and trailers over 12 tonnes (more [in Czech] HERE and HERE). The new road tax legislation should apply retroactively for the 2022 tax year.

Ukraine

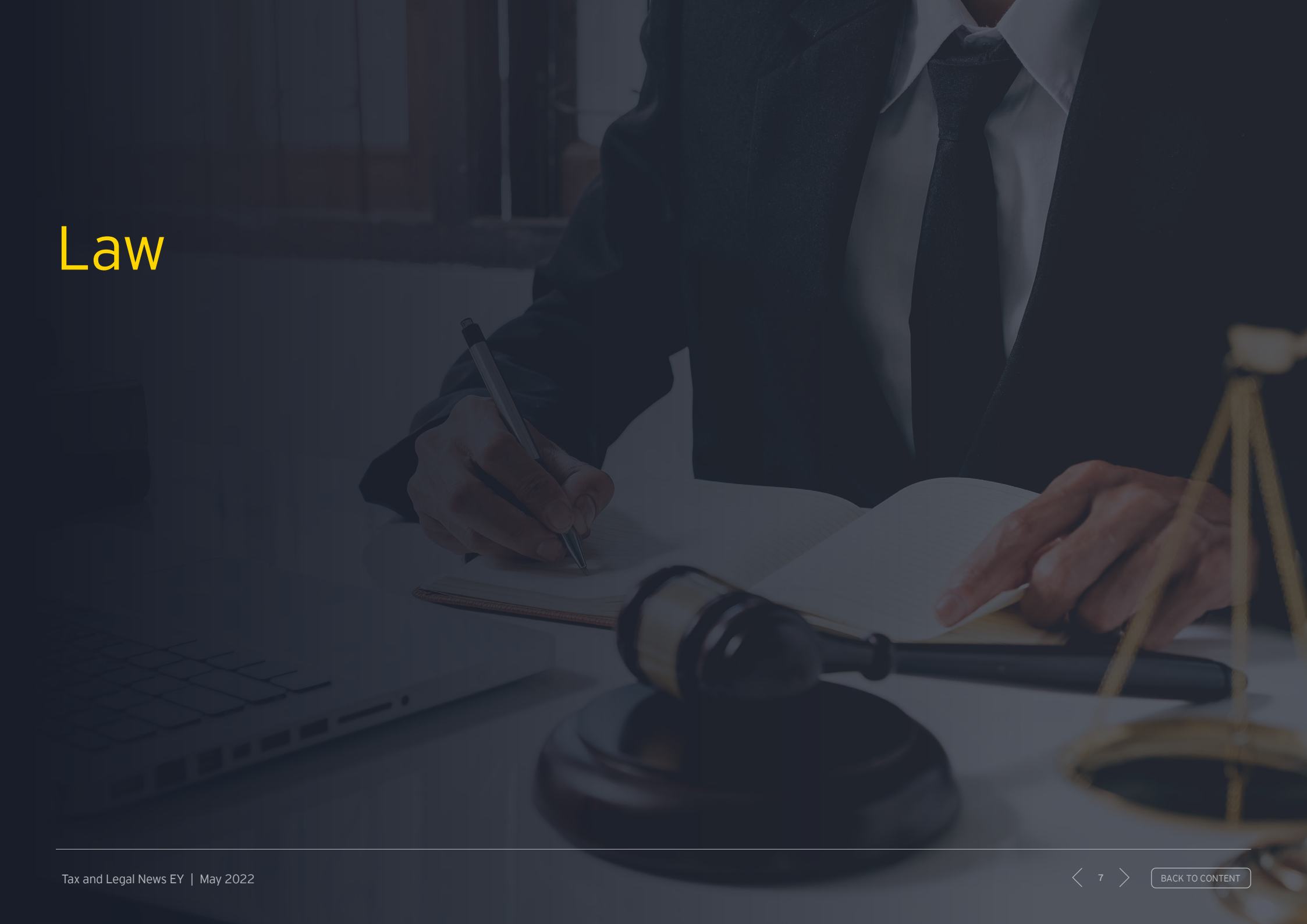
In the context of the events in Ukraine, a bill on tax measures in connection with the armed conflict in Ukraine has passed its third reading in the Chamber of Deputies and later approved by the Senate (Parliamentary Document 173).

This new law includes, in particular, the income tax implications of related consideration-free transactions. Originally, the proposal was to take the form of an Income Tax Act amendment, but it has already been submitted to the Chamber of Deputies as a separate law. More HERE. In this context, it is worth noting that the Ministry of Finance also published [in Czech] Questions and answers on this law, which can provide guidance in dealing with some practical situations.

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

Among other things, in the case of low-emission motor vehicles, it is proposed to reduce the percentage of the input price that is treated as income of the employee for the purposes of the Income Tax Act in relation to the free-of-charge provision of a motor vehicle by the employer for business and private purposes from 1% to 0.5% of the input price of the low-emission motor vehicle.

Law



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Legal presumptions and fictions in contracts

Legal presumptions and fictions in general

Legal presumptions and fictions as legislative-technical instruments are quite common in the legal system. Legal presumptions (usually formulated as "it is presumed") or fictions (usually formulated as "it applies"; "it is deemed"; "it is seen") mean that we presume the existence or consider as having occurred a fact that is not certain to have actually occurred or even certain not to have occurred.

In contracts, parties may wish to formulate a legal presumption (whether revocable or irrevocable) or fiction for various reasons. For example, in the context of sales or work contracts, such arrangements may be driven by the contractor's desire to contractually secure an alternative method of delivery of goods or performance of work (including completion and handover of the work) as a condition of its right to payment of the purchase price or the price of a work. Similarly, the parties may wish to formulate a presumption or fiction in respect of the delivering of documents or in other cases agreed between the parties.

Earlier case law

The Supreme Court has addressed this exceedingly practical question several times in the past. However, it has based its decisions on the legislation in force before the recodification of private law. In its earlier decisions (e.g. in the judgment of 18 March 2010, Case No. 23 Cdo 5508/2007 or in the judgment of 4 March 2020, Case No. 32 Cdo 1287/2018), the Court held that a legal presumption or fiction can only be established by a legal regulation and therefore cannot be validly agreed in a contract. The Court based its rigid conclusion on, among other things, the objective method of interpretation of legal acts preferred by then applicable law and the declared impossibility of modifying the burden of proof (as an institute of public procedural law) by agreement of the parties.

The conclusions of the Supreme Court have been repeatedly questioned by experts, pointing to the autonomy of the will of the parties and the necessity to assess the possible conflict of such agreements with the mandatory provisions of the law on an *ad hoc* basis.

Ground-breaking Supreme Court decision

Now, however, the Supreme Court has departed from its earlier decision-making practice. In its recent decision (the judgment of 23 March 2022, Case No. 23 Cdo 1001/2021), the Court assessed the validity of a provision in a work contract concluded under the new Civil Code (after 1 January 2014) between two entrepreneurs. The subject of the work contract was the reconstruction of a mountain hut. The disputed clause was as follows *"If the customer fails to appear unreasonably and repeatedly (at least twice) for the acceptance of the work or otherwise unreasonably prevents the final handover of the work and the execution of the handover protocol, the work shall be deemed to have been duly and timely handed over."* The intention of the contracting parties was thus to negotiate a fiction of handover and acceptance of the work.

The Supreme Court did not accept the appellant's objection on the invalidity of the agreed fiction and in its decision dealt more generally with both fictions and presumptions. It concluded that an agreement of the contracting parties which used a phrase typical of the expression of a legal presumption or fiction to express a certain legal consequence foreseen by them is not necessarily invalid for being contrary to law or good morals. The Court thus abandoned the strictly formalistic approach based on the old legislation and highlighted that the new Civil Code is based above all on respect for the autonomy of the will and the need to ascertain the true intention of the parties when interpreting legal acts. The actual intent of the parties is emphasized by the law and the courts over its plain language expression in a legal transaction (e.g. in the text of a written contract).

It is therefore necessary to examine carefully in each particular case what is the content of the agreement under consideration in which the wording indicating a legal presumption or fiction has been used. It is also necessary to examine whether the content of the agreement contravenes mandatory provisions of the law and whether it is contrary to good morals. Whether the manner in which the parties have departed from the dispositive legislation is not, in the circumstances, prohibited by law must also be assessed.

Relevant to the conclusion as to the validity of the arrangement is also an assessment of the relationship between the parties to the contract in question, in particular whether it is a balanced relationship between the parties, e.g. two entrepreneurs, or whether one of the parties is the weaker party (whether a consumer or a weaker entrepreneur) against whom the other party has abused its stronger position.

Thus, in the circumstances of the present case, the Supreme Court concluded that the legal regulation of acceptance of the work is a dispositive regulation and it does not preclude a deviating agreement of the parties. In this context, the Court confirmed, inter alia, that it is possible to modify the moment of performance of the work (including completion and, in particular, handover or acceptance of the work) by setting additional preconditions for acceptance of the work, for example by making it conditional on the execution of a handover protocol.

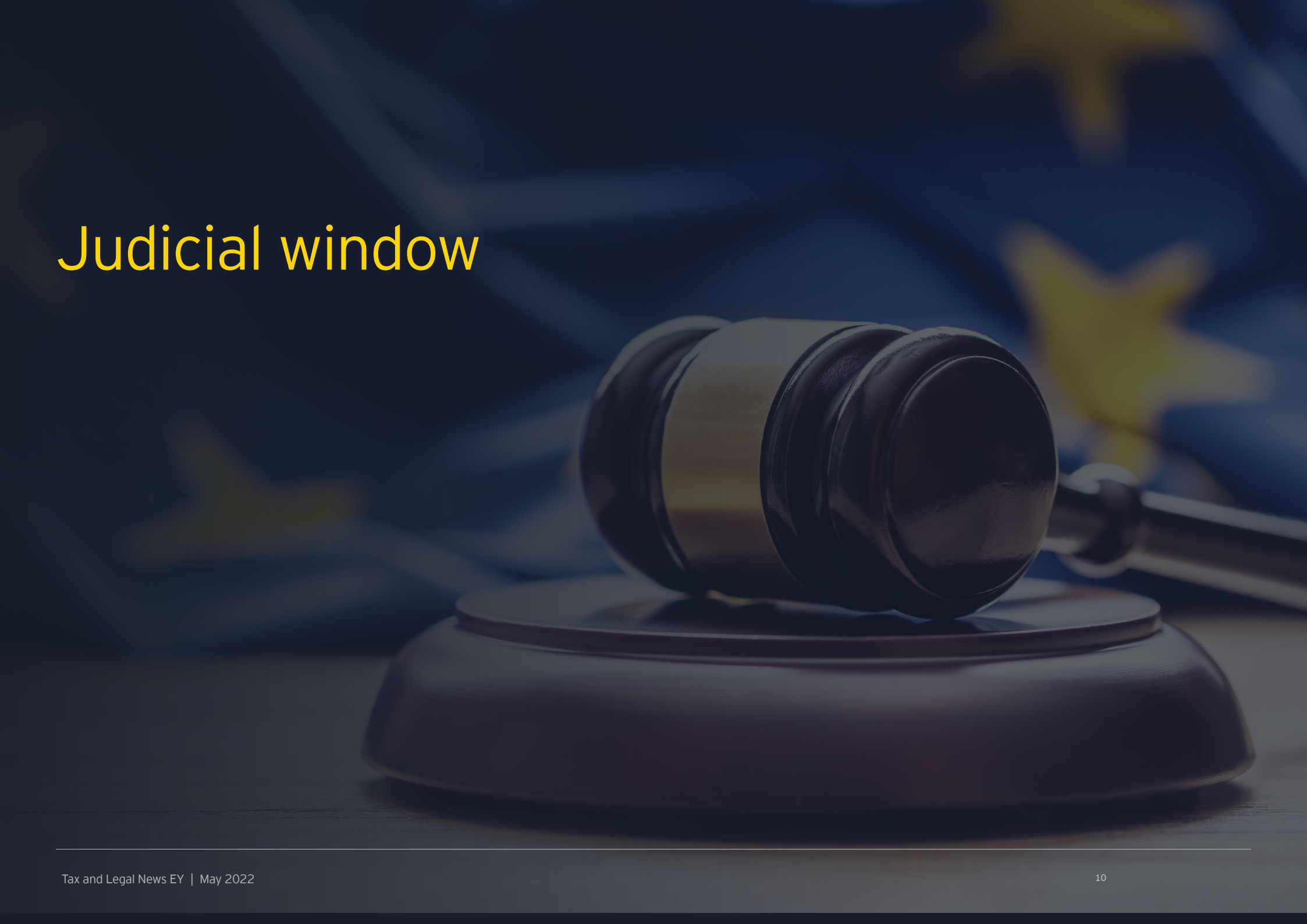
The purpose of the rule agreed upon by the parties was to grant the legal consequences of the client's acceptance of the work under specified conditions. Such an arrangement, according to the Court, is not immoral, taking also into account that the parties (both entrepreneurs) were in a balanced relationship. Therefore, the Supreme Court did not find the use of the legal fiction formulated by the usual phrase "it is deemed" invalid in this case.

As regards the burden of proof, it should be added that in the circumstances of the present case, the Court correctly concluded that the provision of the above-mentioned fiction of handover and acceptance of the work modified the range of decisive facts that the party (the contractor) had to claim and prove in this dispute. This means the contractor bore the burden of proving that the repeated failure to handover the work as foreseen by the parties' contractual arrangements actually occurred.

For more detailed information, please contact the authors of the article or other members of EY Law or your usual EY team.

When entering into purchase or work contracts, the parties may be motivated to secure an alternative method of delivery of the goods or performance of the work, typically in order to satisfy the conditions for the right to payment of the purchase price or the price of the work. In practice, therefore, these contracts often contain so-called legal presumptions or fictions. Until recently, the validity of such arrangements was, at the very least, questionable. However, in its recent decision, the Supreme Court rejected the general conclusion that contractual presumptions and fictions are invalid and outlined the conditions under which they can be validly agreed.

Judicial window



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SAC judgment confirms that a company with a limited functional profile should not realise losses

In this issue, we present a very interesting Supreme Administrative Court (SAC) judgment in the area of transfer pricing concerning the implications of a parent company dictating its pricing policy in respect of related and unrelated parties.

Background

- The dispute concerned a tax period in 2011 in which a Czech company – operating within a multinational group and selling its products both within and outside the group – made a loss.
- According to the tax administrator, the Czech company, which is essentially in the position of a contract manufacturer, incurred a loss in 2011 because it bore risks that it could not control and that were influenced by the parent company together with its sister companies (mainly currency risk in the purchase of inputs and the risk of determining sales prices).
- According to the tax administrator, this loss should have been compensated by the remuneration for services that an independent company in a similar situation would have received. According to the tax authorities, for this "hypothetical service of carrying out loss-making production for the benefit of a multinational group", the company should have received from the group a remuneration equal to the difference between its actual revenue and the revenue it would have generated at an operating profitability of 1.26% (the minimum value from the profit margin range of comparable entities). The tax administrator adjusted the company's tax base by this amount.
- It should be noted that the company first submitted an initial transfer pricing report in the tax proceedings, in which it was characterised as a contract manufacturer performing only limited functions and bearing primarily routine risks. Only later did it submit an updated transfer pricing report, where the company was credited with a greater range of functions and was identified as a licensed contract manufacturer with a functional and risk profile more akin to a full-fledged manufacturer. The tax administrator, however, disagreed with this newly established functional and risk profile of the company and was inclined to accept the accuracy of the original functional and risk analysis, considering

the company's position as a contract manufacturer to be proven.

- The Regional Court agreed with the conclusions of the tax administrator.

Supreme Administrative Court

The Supreme Administrative Court sided with the tax administrator. Below is a summary of selected arguments:

- The SAC rejected the objection that the tax administrator erred in failing to distinguish between transactions carried out with related and unrelated parties. The SAC stated that, according to the overview of the functions of the original transfer pricing report, it is clear that the selection and final approval of material suppliers, the determination of delivery terms, price negotiations and negotiations with end customers on delivery terms are outside the influence of the Czech company. The conclusion that it was not appropriate to analyse individual transactions, as the related parties influenced all transactions, is therefore correct according to the SAC.

- As regards the alleged unfavourable exchange rate development in 2011, the change of component supplier in connection with the March earthquake in Japan and the situation in the automotive industry, according to the SAC, the tax administrator correctly pointed out that since the selection and final approval of material suppliers, the determination of delivery terms, price negotiations, negotiations with end customers on delivery terms and marketing negotiations were functions that the company did not perform, then the risks associated with them should not be attributed to it either (i.e. price, capacity and currency risk, including the risk of dependence on key suppliers and customers).

- As regards the argument that the company's profitability was positive between 2013 and 2015, the SAC found this fact irrelevant to the assessment of the case.

- The objection that the Regional Court erred in accepting it was irrelevant which of the related parties was to compensate the company for risks that an independent entity would not have tolerated is also unfounded, according to the SAC. The subject compensation for services rendered should be claimed by the company against its parent company, which is also the managing entity of the group. This fact is also apparent from the original transfer pricing report, where, with respect to the functional and risk analysis, the relationship between these companies was characterized as that of a principal and a contract manufacturer (the company) performing only limited functions and primarily bearing the risks corresponding to its production activities. Moreover, from the point of view of the application of § 23(7) of the Income Tax Act, the determination of the specific related person who was to compensate the company for the risks is indeed not decisive, according to the SAC. What is important is that the company bore such risks for the benefit of the multinational group and was not adequately compensated to the extent necessary to achieve at least a minimum operating profitability.

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

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Regional Court in Brno on the nature of income from the sale of bitcoin

The Brno Regional Court ("RC") ruled in a case concerning the sale of bitcoin by an individual taxpayer in relation to the potential exemption of such income under § 4(1)(ze) of the ITA, which regulates exchange gains on the exchange of money (Ref. No. 30 Af 29 / 2020 – 48).

In 2017, the taxpayer sold a portion of the bitcoin it had purchased between 2011 and 2015 and reported the sale on its 2017 regular tax return under other income pursuant to § 10 of the ITA. It paid the related tax at the same time.

The very next day, the taxpayer filed a supplementary tax return that no longer included the bitcoin sale. The taxpayer then responded to the tax authority's request by referring to § 4(1)(ze) of the ITA, according to which the sale of bitcoin should be regarded as an exchange activity exempt from income tax.

However, the tax administrator and subsequently the Appellate Tax Directorate rejected such a procedure on the grounds that the sale of bitcoin was not covered by the provision in question, as bitcoin cannot be considered money or foreign currency, and the transaction was therefore subject to taxation.

The RC dealt exclusively with the question of whether the income from the sale of bitcoin constituted an exchange gain on the exchange of money from a foreign currency account and was therefore exempt from income tax. The RC's line of argument can be summarised as follows:

- The provisions relating to the exemption of income from tax constitute an exception to tax liability and should therefore be interpreted restrictively.
- The term "exchange of money" can only mean the mutual exchange of money having a cash equivalent.

- Bitcoin cannot be considered a foreign currency, which is exclusively money issued by foreign central banks, the circulation of which is regulated by those banks. In other words, only currency that is subject to similar rules abroad as domestic currency can be considered a foreign currency.
- Bitcoin is an unregulated virtual currency or virtual asset which is not subject to the regulation and supervision of any central bank in the world; at the same time, according to the Court, there is no doubt that bitcoin cannot be considered to be money within the meaning of the Payment Act.
- The Act on Certain Measures against the Legalization of the Proceeds of Crime and the Financing of Terrorism also does not provide support for the argument that virtual currency constitutes a means of money under the Payment Act or "money" under § 4(1)(ze) of the ITA.
- The exchange of bitcoin for Czech or foreign currency does not meet the characteristics of an exchange transaction under the Exchange Act.

The RC thus concluded that the taxpayer's income from the sale of bitcoin constitutes income failing to meet any of the characteristics of an exemption under the ITA and, as such, is subject to taxation under § 10 of the ITA.

It should be stressed that the RC considered this issue for the 2017 tax year. The possible development of virtual currencies and their assessment in global jurisdictions may bring other interpretative conclusions in the future.

It is worth noting paragraph 31 of the judgment in which the RC suggests that if bitcoin is used to pay for goods and services, such a transaction should not be subject to taxation under § 10 of the ITA. However, this reference is not entirely consistent with the rest of the text and conclusions of the judgment. It also contradicts previous interpretations of the tax administration, which indicate that this is a standard taxable exchange (for more in Czech, see here).

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

The RC thus concluded that the taxpayer's income from the sale of bitcoin constituted income that did not meet any of the characteristics of an exemption under the ITA and, as such, was subject to taxation under § 10 of the ITA.

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Extended Chamber of the Supreme Administrative Court to consider essential costs

An extended chamber of the Supreme Administrative Court (SAC) has been faced with the question of when the tax administrator should proceed to a determination of essential costs by means of aids.

Essential costs

Taxpayers bear the burden of proof for the facts stated in their tax returns.

In practice, a taxpayer may not have sufficient evidence to prove the costs incurred, either because of poor record keeping or because they fail to meet the high standard of proof required by the tax administrator.

The administrative courts concluded that in the case of costs which had to be logically incurred in order to generate income, but whose actual amount was not reliably proven, it was not possible to completely disregard such costs (so-called essential costs).[1] The tax administrator should then proceed to their determination by means of aids.

Typical examples of essential costs may be construction work (repairs) clearly carried out on the taxpayer's property, but for which the taxpayer has insufficient evidence. Of course, there is no precise list of essential costs. It is basically up to the taxpayer to argue why a particular cost is an essential cost.

Question dealt with by the Extended Chamber of the SAC

The question of the conditions under which the tax administrator should proceed to determine essential costs by means of aids has come before the Extended Chamber of the Supreme Administrative Court[2].

One line of the case law suggests the tax administrator should switch to aids in situations where a particular type of cost is substantially questioned or where the taxpayer's costs are insufficient, after excluding specific tax-effective costs, to carry out the contract in question. Even where a marginal part of the accounting is disputed, the inclination is to switch to aids.

1 SAC Decision No. Afs 160/2016 - 38
2 SAC Resolution No. 8 Afs 296/2020 - 106

In our view, this is the example of unproven construction costs that make up only a marginal part of the costs on the taxpayer's books in a given year.

The second line of the case law (which, according to previous decisions, has been upheld by several chambers of the SAC)[3] concludes that the failure to recognise a particular cost or a particular group of costs cannot be the sole reason for the determination of tax using aids. According to them, a key criterion for fulfilling the statutory conditions for determining tax according to aids is the ratio of the excluded costs to the total costs (individual decisions mention that a ratio of even slightly over 10% of the questioned costs to the total costs of the tax entity is insufficient to switch to aids), or the amount of the questioned accounting as a whole. Challenging a marginal part of the accounting is therefore not a reason for switching to aids.

The Referring Chamber is inclined to the second line of reasoning, noting that in the case of an input obtained at a non-market value (e.g. the use of under-the-table workers), through criminal activity or by donation, the essential cost of the market value awarded by the aids could exceed the cost actually incurred.

In our view, in the event of a decision by the Extended Chamber in favour of the latter line, the possibility of claiming essential costs by way of aids would be substantially restricted. This option would presumably remain available only to entities for which the essential costs represented a substantial part of the expenditure (typically, an entity carrying out one specialised activity would be able to reach them; an entity carrying out four specialised activities with one activity with problematic underpinnings would be more likely not to).

Reliance on aids

Relying on essential costs may be one appropriate line of defence in the event of a difficult evidential situation for a tax audit. However, in our opinion, this should not be the primary method of proof (the taxpayer keeps records recklessly because they believe that in the event of a tax audit aids will be relied upon).

The Supreme Administrative Court stated that aids are not a means of summarizing tax proceedings or a tool to punish the tax entity, but a basis for a qualified estimate of relevant facts based on information known to the tax administrator about the tax entity, other persons and general conditions in a particular market.[4]

However, the defence against aids set by the tax administrator is not limitless and the taxpayer cannot assume an aid will be set at the exact level expected and defend against it without limitation.[5]

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

In our view, if the Full Court were to rule in favour of the latter line, the possibility of claiming essential costs by way of aids would be substantially restricted. This option would presumably remain available only to entities for which essential costs represented a substantial part of the expenditure (typically, an entity carrying on one specialised activity would be able to obtain them, an entity carrying on four specialised activities with one activity with problematic supporting documents would be more likely not to).

3 represented, for example, by the Fourth, Eighth or Ninth Chambers of the SAC

4 SAC Decision No. 7 Afs 142/2014-28

5 For more detail, see Decision No. 8 Afs 69/2010-103)

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Supreme Administrative Court on the tax treatment of exchange rate differences

We would like to draw your attention to a recent judgment of the Supreme Administrative Court (SAC), which, though it primarily concerns proving received services, also contains interesting passages concerning the tax treatment of exchange rate differences (Ref. No. 4 Afs 270/2021 - 105).

We find the following two passages of particular interest:

- The first concerns the (non-)taxation of exchange rate differences: *"The Supreme Administrative Court dealt with the issue of including unrealised exchange rate differences in the tax base of the tax entity... . In doing so, it concluded that unrealised exchange differences reflect a situation that has not yet occurred and is merely simulated for accounting purposes, in order to recognise the amount of the liability in Czech currency. The gain can only be the appreciation of the koruna against the foreign currency accompanied by a physical flow of money, which, however, is only clear at the date of the financial transaction. Thus, a distinction should be made between "exchange differences" arising from mere translation (unrealised exchange differences) and actual 'exchange gains or losses' (realised exchange differences). Unrealised exchange rate differences do not constitute taxable income, as they arise only on the basis of translation and have no relevant basis in the disposal of assets (operational activities of the business entity) and have no influence and impact on economic productivity or the economic result. They are effectively only virtual profits (or losses) which are not included in the tax base... ."*.

- The second passage concerns the relationship between exchange differences and tax non- deductible expenses: *"... In agreement with the complainant and in view of the conclusions formulated in its earlier case law, the Supreme Administrative Court adds, obiter dictum, that it would be illogical that, in the event of non-recognition of a certain expense incurred by the complainant pursuant to § 24 of the Income Tax Act, the related unrealised exchange rate difference should continue to form part of the tax base."*

After reading these passages, the following questions come to mind:

- Does the SAC believe that unrealised exchange rate differences are not taxable even under the current regulations (or is it just commenting on the situation as of 2013, i.e. for the period before the Income Tax Act amendment, which was in fact a reaction to judgments concerning the

non-taxation of unrealised exchange rate differences)?

- And most importantly – can this judgment be read as calling into question the current prevailing practice of generally including exchange rate differences in the tax base regardless of the nature of the "underlying" costs/income?

It will certainly be interesting to follow future developments in this area.

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

Can this judgment be read as calling into question the current prevailing practice of generally including exchange rate differences in the tax base regardless of the nature of the "underlying" cost/income?

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Supreme Administrative Court on abuse of law in contractual penalties

We would like to draw your attention to a recent Supreme Administrative Court (SAC) judgment concerning abuse of law in connection with contractual penalties.

In simple terms, this was a situation where a company purchased receivables from related companies. The purchased receivables quickly proved to be (mostly) difficult to collect; subsequently, the company did not have the money to pay the related receivables purchase obligations and in this context paid a later agreed contractual penalty for late payment of its debts. This contractual penalty which was paid via offset was claimed as a tax expense.

According to the tax administrator, the company formally fulfilled the conditions for claiming of the contractual penalty as a tax expense. At the same time, however, the tax administrator (in agreement with the Regional Court) concluded that the imposition of the contractual penalty, or rather the company's conduct which enabled its imposition, and its subsequent claiming as a tax expense, was an abuse of law. Among other things, it pointed out that the company had written off most of the debts in question and had not taken a single step to recover them. On the contrary, in the case of its own debt, it repeatedly agreed to a contractual penalty and issued a promissory note for the entire debt.

The Supreme Administrative Court sided with the tax administrator (and the Regional Court) and agreed with the application of the abuse of law in the case at hand, while examining in detail the rationality of the company's actions. In agreement with the tax administrator, the Court did not see anything in the company's actions that could rationally explain its conduct; on the contrary, it was an artificial creation of conditions for the imposition of a contractual penalty.

A few selected observations that caught our attention in the judgment:

- According to the SAC, there is no reason why "abuse of law" now formally regulated in the Tax Code (modification of Section 8[4] of the Tax Code) should mean anything other than "abuse of law" found earlier in tax practice and case law.
- A situation in which a tax entity intentionally creates conditions for the imposition of a contractual penalty, the payment of which is then claimed as a tax expense, must be considered as possible abuse. Thus, it is not necessary to artificially classify cases of abuse of law under § 23(7) of the Income Tax Act (ITA) and to resolve them by the tax

administrator adjusting the tax base by the entire payment of the contractual penalty (as proposed by the company).

- If the abuse of law is examined in the context of the application of the payment of a contractual penalty as a tax expense, the tax authorities "need" to exclude the rational element both in the conclusion of the agreement of which the contractual penalty arrangement is part and in the subsequent conduct of the company which caused the imposition of the contractual penalty.

- In assessing the subjective condition, all relevant objective circumstances of the case must be taken into account, even if the tax authority has already applied the objective element in the solution. On this basis, the tax authority must rule out rational justification for the taxpayer's conduct and find an artificial construction used to obtain a tax advantage.

- The law gives taxpayers the option to claim the penalty paid as a tax expense. However, according to the Supreme Administrative Court, the logic of § 24 as a whole and specifically paragraph 2(zi) of the ITA must be contradicted by the application of a contractual penalty which has no meaningful link to the economic activity of the complainant.

- The company also argued that its conduct could not be an abuse of law because no profit was generated in the group of companies linked by property and personnel (according to the company, the counterparty entered the contractual penalty in its books and taxed it). According to the SAC, even this argumentation cannot refute the conclusion that the entire transaction is artificial. The essence of the "artificiality" of the complainant's conduct lies, first of all, in its conduct prior to the actual set-off of the claim. Moreover, the company's conduct enabled it to reduce its tax base and even to recognise a tax loss. Even if the counterparty had indeed entered the set-off receivable in its accounts as the company claims, this could hardly explain the company's conduct. The SAC points out that when examining abuse of law, it is often necessary to look beyond the formal entries in the accounts of taxpayers and examine the economic sense of their actions.

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

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- The European Commission has published a study on the cost of tax compliance?