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Tax and Legal Update

Tax news
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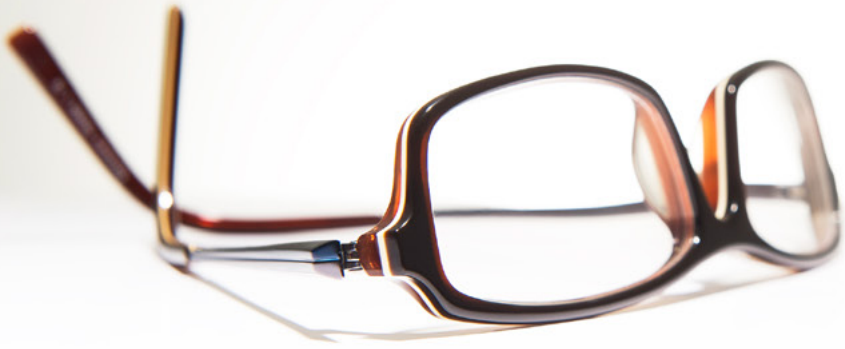
Case law



February 2016

Dear Readers,

Leap years tend to provoke mixed feelings. Although well-liked by employers, they are not very popular with employees as they add an extra (working) day to the year.

Leap years have also played an important role in Czech law and history. In fact, the first constitution of the fledgling Czechoslovak Republic was passed on 29 February 1920. In a very progressive way, the constitution's preamble stressed the need to implement legislation (including tax regulations) in accordance with our historical as well as modern principles. As demonstrated by the recent trend in tax rulings, our present-day judiciary has not only not deviated from this course, it is increasingly reinforcing it. However, not all leap-year Februaries in Czech history have been this progressive, even though their official titles might suggest otherwise.

In terms of tax legislation, this February is shaping up to be an important month. Legislators have chosen it to implement a new concept of reporting value added tax. For the first time ever, we will thus electronically file VAT ledger statements, disclosing to the tax administrator the details of all our transactions. The volume of data kept and analysed by the authorities will be immense.

Hopefully, the scepticism of pundits will prove unfounded and taxpayers won't have to stare at an endlessly spinning circle on their computer screens. When the first VAT ledger statement is processed, let's keep our fingers crossed that the contest between man and machine ends just like the one in February 20 years ago. Back then, the first match between IBM's Deep Blue supercomputer and Garry Kasparov was won by the human grandmaster. Similarly, this February is destined not to be victorious for all.

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Abuse of law back on stage

The new SAC case law on VAT highlights the role of the abuse of law concept yet again. Apparently, the doctrine's popularity with judges has not yet reached its peak, and SAC judges now comment on it also in separate articles, as was the case for a recent crucial judgement concerning the application of the abuse of law principle in corporate reorganisation.

The abuse of law concept is reprising its role as the hit of this and last year's seasons. The Supreme Administrative Court (SAC) applied this doctrine in one of its first judgements published this year (4 Afs 192/2015 -27). The case involved a rather „innocent" situation: claiming VAT deduction on an advance invoice paid by off-setting receivables between companies belonging to members of one family. The judges found nothing to justify the challenged invoicing but a tax motive.

Perhaps the most noticeable recent judgement dealing with this concept is the widely discussed CTP case: the SAC perceived the abuse of law in a deduction of interest on a loan granted by a related party for a purchase of shares in companies acquired within an intra-group reorganisation. So did the case engage the attention of SAC judge Karel Šimka that he expressed his criticism of the sophisticated restructuring scenario not only in his judgement, but also in a separate article titled "For whom the bell tolls? It tolls for thee, international tax optimisation!" Leaving aside now the literary heading, the judge's reflections upon investigating the whole restructuring scheme are worth noticing: the economic reasons for the restructuring as suggested by the group in the scenario seemed so „fictitious, artificial and without any substance" to them, that the SAC could do nothing but rate the whole transaction as "without no clear economic reason" aiming to "siphon profits from the Czech Republic".

According to the judge, none of the elements used in the restructuring would, in itself, damage the quality of the "play"; he explicitly stated that he does not condemn the scenario of related-party loan financing, or the possibility of purchasing a majority share in a company with a subsequent merger – provided that these are all composed into an economically reasonable performance. What matters is the overall picture of the series of transactions, viewed also from the perspective of their foreign implications. The judge gives examples of what would potentially meet his idea of economically reasonable objectives of intra-group reorganisation: for instance the acquisition of a new company, gaining a new market, saving costs or simplifying the administrative structure of the group. Besides such reasons, he admits a "coexistence" of a reason touching on the tax aspects of the transactions. However, such a coexistent reason must not take over the main role in the play or out-stage the other, non-tax motives.

The recent judgement, and the critical article by Judge Šimka further confirm the conclusion that the abuse of law concept remains highly popular and may be applied to any tax, transaction or series of transactions of any type, wherever non-tax related reasons cannot be simply, logically and clearly explained to the tax administrator, or, consequently, to the court.

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Change in reverse charge mechanism application

January 2016 has also brought long-awaited changes in the application of reverse charge mechanism. The government has approved an amendment to the relevant regulation. The changes take effect on 1 February 2016.

A positive feature of the amendment is the option for sellers and purchasers to conclude an agreement on the application of a reverse charge mechanism on deliveries of goods with no limit on the goods' value. It was formerly possible to apply the mechanism only if the value of supplies (e.g. deliveries of crops, selected electronic equipment and other commodities) exceeded CZK 100 000. The agreement must be concluded in writing. This will definitely be welcomed by payers who deliver or purchase relevant goods both below and above the limit and who until now had to check the value of each individual supply to apply the correct mechanism.

The amended regulation extends the application of the reverse charge mechanism to deliveries of electricity and gas where the purchasers of these "goods" are either electricity or gas traders. For the purpose of the regulation, traders are not only persons purchasing electricity or gas intended primarily for re-sale and whose own consumption of these goods is immaterial, but also any other persons whose principal activities are electricity transmission and distribution, trading in electricity, market operator activities, gas transportation, distribution and storage and trading in gas under conditions laid down in the Energy Act.

The reverse charge mechanism will thus be applied when an electricity producer delivers electricity to a distribution company or in respect of any other electricity or gas supplies to persons possessing the relevant trading or distribution licences, irrespective of whether they actually use the licence or re-sell the purchased electricity or gas.

Irrespective of the value of a delivery or of the recipient, reverse charge mechanisms will also be applied to transfers of guarantees of origin according to the Act on Supported Energy Sources.

As regards the application of the reverse charge mechanism in respect of deliveries of electricity and gas, the General Financial Directorate has also published its pertaining Information available on the web site of the tax administration.

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Treaty with Lichtenstein to impact certain provisions of Income Tax Act

In January a tax treaty with Lichtenstein started to apply. As Lichtenstein is part of the European Economic Area (EEA), the treaty has an impact on a number of significant provisions of the Income Tax Act.

A bilateral double taxation treaty has come into operation between the Czech Republic and Lichtenstein, which as a member state of the European Economic Area is now entitled to similar advantages arising from European directives as EU companies. Accordingly, the legal basis for the exchange of information on taxpayers with Lichtenstein's tax administration has been awaited rather impatiently. The exchange of information was a pre-condition for using advantages from European directives. We draw attention to the following rules:

- A permanent establishment for construction work exists if a 12-month time test has been fulfilled, while a permanent establishment for the provision of services arises once a six-month time test is fulfilled in any 12-month period.
- Dividends can be tax-exempt in the source country only if the company receiving dividends has been holding at least 10% of the capital share in the divided paying company for at least one year. In other cases a rate of 15% is applied.
- Interest is taxed only in the country of the recipient's residence.
- Copyright royalties are not taxed in the source country, while industrial property royalties can be subject up to a 10% tax in the source country.

The treaty contains two specific adjustments not often seen in treaties concluded by the Czech Republic: mutual tax collection assistance and denial of contract benefits if law is abused. A relatively exhaustive protocol concluded alongside the treaty explains and details a number of other rules.

Since January, amendments to double taxation treaties with Belgium and Ukraine apply; in both of these amendments, an article on the information exchange between tax administrations has been harmonised with OECD standards. A treaty with Iran and the amendment to a treaty with Kazakhstan are awaiting the approval by the parliament and ratification. The Czech Republic currently applies treaties on the exchange of information in tax matters with nine states. Similar treaties have been signed with Monaco, the Cook Islands and Aruba, although they are not in application yet.

The Czech tax administration has recently extended the use of international information exchange tools and this trend can be expected to grow. During last year's inspections focused on tax havens it additionally assessed 50 million crowns and intends to continue in this vein this year, as mentioned in its web site report.

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New Customs Procedure Code under preparation

As of 1 May 2016 the existing Customs Act will be replaced with the new Customs Procedure Code harmonised with European legislation. In addition to a number of changes in terminology, it brings specific changes in tax laws.

Customs in the Czech Republic are primarily regulated by the Community Customs Code and its implementing regulation; the domestic legal regulation adopting the Community Customs Code is the existing Customs Act (Act No. 13/1993 Coll.). As of 1 May 2016, the Community Customs Code will be fully replaced by the new Union Customs Code; accordingly, the Czech Republic will issue new Customs Procedure Code replacing the existing Customs Act. The new rules bring a number of changes in terminology, e.g. the cancellation of some terms (free warehouse, customs procedure with economic impact, suspensive procedure, inward processing).
Apart from the above changes in terminology, the new regulation reduces the administrative burden on businesses, e.g. in the following areas:

- Direct representatives in customs clearance procedures will be entitled to provide a customs deposit for the person they represent.
- The repeated use of lodged deposits to secure customs debt will be possible; simplifying the customs clearance mainly for small and medium-sized importers.
- The administration of customs through indirect representation and data correction in a customs declaration will be simplified.

The new legal regulation requires the amendment of related legislation, including tax laws. In addition to the changes introduced by the Union Customs Code, the following changes have been proposed to amend the Value Added Tax Act:

- Change of local jurisdiction for persons liable to tax who have no registered office or place of business from the tax authority for the City of Prague to the tax authority for the Moravian-Silesian region;
- Cancellation of the exemption from value added tax upon the release of goods into a free zone; the delivery of goods into a free zone and provision of services relating to these goods will newly be a taxable supply with an entitlement for a tax deduction.

The government has yet to present the Customs Procedure Code and related amendments to the parliament. Additional changes or amendments during the legislative approval process cannot therefore be excluded.

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Supreme Court on Commercial Register entries

Most regulations relating to the recodification of private law have been in effect for three years. However, this is not long enough for legal practice – e.g. this can be substantiated by the non-uniform approach of the courts when deciding on proposed entries in the Commercial Register. To provide greater certainty regarding these issues, the Supreme Court decided to issue an opinion unifying the decision-making practice of lower instance courts.

The vast majority of conclusions that the civil and commercial collegium presents in its opinion (file no. Cpjn 204/2015, dated 13 January 2016) apply to limited liability companies as the most frequent form of corporation in the Czech Republic. The Supreme Court has, among other things, come to the conclusion that various types of shares (e.g. priority shares or shares without voting rights) can also be created in companies that were registered prior to the recodification (i.e. before 1 January 2014) and did not conform to the Corporations Act as a whole. Interestingly, one of the arguments here was that the two-year time-limit to conform to the new act (opt-in) is a procedural time-limit (i.e. upon its lapse the right does not cease to exist and the time-limit can be extended). Accordingly, it can be assumed that although the statutory time-limit expired on 31 December 2015, the opt-in is still possible and registration courts will still have to enter it in the Commercial Register.

As regards entering information on share types in the Commercial Register, the Supreme Court came to the conclusion that if a company owns only basic shares (i.e. without any special rights and responsibilities), this information shall not be entered in the Commercial Register. Similarly, the information that a company does not issue securities representing shares (ordinary share certificates) shall also not be recorded.

The Supreme Court also finally answered the question that split the legal public into two camps. The court inclined towards the prevailing opinion that notarial records are not necessary for decisions of general meetings of limited liability companies approving share transfers to a third party (outside the company). Instead, it will be sufficient if the transfer is approved by a simple majority of the shareholders present. The same procedure shall apply if shares are split as part of their transfer.

The Supreme Court has also dealt with the issue of joint stock companies. It concluded that in a joint stock company with a monistic system (without a board of directors and supervisory board, but an administrative board and statutory director) any member of the administrative board can be the statutory director, not just the chairperson of the board.

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Can employers check their employees' mail?

The European Court of Human Rights (ECHR) issued a judgement in mid-January on the issue of the conflict between an employee's right to privacy, and an employer's interest in the efficient utilisation of working hours. It confirmed that a Romanian employer was within its rights to monitor its employee's emails. Although the ECHR based its decision on an international treaty which is also binding upon the Czech Republic, it should not be interpreted as sanctioning the unlimited monitoring of employees' activities at Czech workplaces.

The case was referred to the ECHR on the basis of a complaint of a Romanian citizen, who claimed that the Romanian courts failed to provide sufficient protection to his right to respect for his private life and correspondence as guaranteed by the Convention for the Protection of Human Rights and Fundamental Freedoms, since they dismissed his lawsuit challenging the validity of termination of his employment.

The employment was terminated by the employer because, despite an explicit ban, the employee had attended to his private email correspondence during working hours using the company's computer. The employer discovered the employee's breach of internal regulations by inspecting the content of his correspondence.

The ECHR stated that employees' right to privacy is not illimitable, and that in the case in question there had been no violation of the Convention. According to the ECHR, Romanian legislators have established adequate rules to balance employees' rights and employers' interests. According to the Romanian Labour Code, an employer may check how employees carry out their tasks, while the data obtained have to be carefully safeguarded. The judgment is not yet final, as both parties may appeal to the Grand Chamber.

The EHCR judgement does not introduce any changes for Czech employers, as they have to observe Czech legal regulations providing for broader protection of employees' privacy than Romanian legislation. Under the Czech Labour Code, employers may systematically monitor employees' emails only if they have a serious reason to do so; employees always have to be informed of the manner and scope of such monitoring, in writing and in advance. The Office for Personal Data Protection also applies a strict interpretation and holds that employers may check the flow of an employee's correspondence, but not the content. Furthermore, the Ministry of Labour is preparing an amendment to the Labour Inspection Act stipulating strict penalties for any breaches of employees' privacy.

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Significant market power

The president signed an amendment to the Act on Significant Market Power aiming to better protect suppliers against the unfair practices of retail chains. According to the Czech Confederation of Commerce and Tourism, the amendment may increase food prices and allow for the bullying of buyers (i.e. retail chains) even though any concerns about price increases have previously been downplayed by the Office for the Protection of Competition.

During discussions in the chamber of deputies, the right-wing opposition had not succeeded in voting it down or having it revised. However, already in May 2015, Top 09's Miroslav Kalousek proposed the abolition of the act as a whole; this proposal, however, has not even gone through the first reading yet. Apart from the opposition, retail chains also strongly oppose the bill and claim that it will increase food prices.

According to its proposers, the amendment aims to provide increased protection to suppliers against unfair contractual conditions imposed by retail chain buyers but only affects certain (sectorial) groups of buyers.

The bill newly defines significant market power and its abuse, introducing the term buyer alliance for any cooperation between buyers. The original definition of significant market power lacked any uniform interpretation, and was rather unclear. The amendment therefore introduces more general definitions. It also applies an absolute concept, whereby a buyer meeting certain criteria will be deemed having significant market power not only in relation to a specific supplier but generally in relation to all.

Examples of the abuse of significant market power include, e.g.: charging a fee or other consideration for introducing certain groceries to stores (stocking fee), slotting fees/shelf-space fee for placing products at more attractive locations within in the store.

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The Commission starts implementing 2016 agenda

The European Commission's Anti-Tax Avoidance Package released in January contains an Anti-BEPS Directive tackling aggressive tax planning, a recommendation on double tax treaties, and a revision of the Administrative Cooperation Directive introducing country-by-country reporting.

The Commissioner for Economic and Financial Affairs, Pierre Moscovici, presented the commission's programme in the area of corporate income taxation for 2016. Its main elements are the Anti-Tax Avoidance Package (Anti-BEPS Directive) and a re-launch of the Common Consolidated Corporate Tax Base (CCCTB). The Commission also encourages the enhanced cooperation of some of the member states (including France, Germany or Austria) who want to introduce a financial transaction tax within their countries.

The commission started implementing the programme in late January, publishing an extensive Anti-Tax Avoidance Package, which contains a number of initiatives with the aim of a coordinated approach of all EU member states in tackling corporate tax avoidance. The package covers the main initiatives presented by the Commission in the course of 2015, including, among others:

- an Anti-BEPS Directive proposing a set of legally binding measures which member states will have to implement to prevent aggressive tax planning;
- a Recommendation on Tax Treaties, which advises member states to revise their tax treaties to prevent their abusing for aggressive tax planning;
- a revision of the Administrative Cooperation Directive, which will introduce country-by-country reporting. Multinational companies exceeding a certain turnover should report selected information by individual countries in their country of residence.

The commission emphasized that although the introduction of the CCCTB as a comprehensive solution to profit shifting between the states is still planned, it is not possible to wait for such solution and action against the main areas of tax avoidance has to be taken now.

The commission's package complements and reinforces the OECD/G20 BEPS project. It seeks to enshrine certain BEPS measures in EU law; this means that the member states will deliver on their BEPS commitments in a coordinated way, on an EU level.

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The commission released its Anti-Tax Avoidance Package one day after 31 countries signed the OECD multilateral agreement on the automatic exchange of information obtained through country-by--country reporting within the BEPS project. This agreement, which was also signed by the Czech Republic, will facilitate the implementation of standards for the exchange of reports within transfer pricing (Action 13 of the BEPS Action Plan). The Czech Ministry of Finance will have to draft relevant legislation, under which some companies resident in the Czech Republic will have to prepare country-by-country reports for the whole multinational group and submit it to the tax administration on a regular basis. The reporting duty will apply to groups of related parties with consolidated profits of at least EUR 750 million for the fiscal year.

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Belgian tax administration to recover up to EUR 700 million

In January, the European Commission issued its final ruling in the matter of the Belgian scheme granting selective tax advantages to multinationals. It firmly concluded that such a scheme is illegal under EU state aid rules.

The European Commission issued its final ruling in the matter of the Belgian scheme granting tax advantages to Belgian companies that are part of multinational groups. Based on advance pricing agreements issued, these mostly European manufacturing companies could have ended up not paying taxes on more than 50%, and in some cases up to 90% of their actual profits, which were not taxed anywhere.

The European Commission concluded that this constituted granting a selective tax advantage without any justification and goes against EU state aid rules. The EC estimates that at least 35 multinational companies benefited from the scheme and the amount (of the unpaid tax) to be now recovered by the Belgian tax administration from the Belgian companies may amount up to EUR 700 million.

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Entitlement for VAT deduction from non-VAT payer?

The Supreme Administrative Court (SAC) in its recent judgement stood up for the taxpayer, admitting the possibility of claiming VAT deduction on a supply received from a supplier whose VAT registration had been cancelled for failing to meet tax duties.

The taxpayer argued that he acted in good faith, which should protect his entitlement for VAT deduction; namely he stated that before entering into business with the supplier, he checked the supplier's VAT registration, which was subsequently cancelled just before the first supply.

The SAC, however, refused to deal with the issue of good faith at this stage of the case. Referring to the judgement of the Court of Justice of the European Union in the Dankowski case, the SAC confirmed that the absence of a formal registration in itself does not constitute a reason for denying the entitlement for deduction if the supplier exceeds the turnover limit for obligatory VAT registration. In the SAC's opinion, cancellation of the VAT registration on the grounds of the failure to meet tax duties cannot automatically lead to denying the entitlement to deduction. It is thus of key importance whether the supplier in questions did actually exceed the turnover limit of CZK 1 million; if the supplier exceeded the limit, the taxpayer's entitlement for deduction would have to be preserved. Since the decision on the cancellation of the VAT registration does not address this issue, it cannot automatically constitute a reason for denying the entitlement for deduction. The SAC thus returned the case to the tax administration for further proceedings.

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To file or not to file (an additional tax return prior to a tax inspection)?

So far, the question whether it is safe to file an additional tax return before the start of a tax inspection has not been unambiguously answered. In practice, most tax administrators have accepted or at least tolerated additional filings. In one of its recent judgments, the Supreme Administrative Court confirmed this approach.

The Supreme Administrative Court addressed the case of a taxpayer who filed an additional tax return for an increased tax loss one day before the planned start of the tax inspection (file no. 10 Afs 105/2015). The Court did not find anything wrong with this approach, but instead pronounced it legitimate for taxpayers to carry out an accounting review before the announced tax inspection where during this review they may find that they need to adjust the last known amount of the tax liability. According to the Court, taxpayers are justified in assuming that if their tax liability increases or their tax loss is reduced based on the additionally filed tax return, the tax authority will not impose a penalty, whereas it could do so if it assessed any additional tax based on the inspection.

The Court thus indirectly approved the procedure applied by the tax administrator which in that particular case postponed the tax inspection until the assessment of the tax loss based on the additional tax return. Only if there are doubts regarding the accuracy of such an additional tax return would it be fully legitimate to start the tax inspection before assessing tax based on the additional tax return and to eliminate any doubts during the inspection. We can thus conclude that the Court would not support the much feared approach in which the tax administrator automatically takes the additional tax return filed before the start of the inspection only as supporting documentation for the additional tax assessment during the tax inspection.

Curiously, in the given case the taxpayer had calculated the amount of the tax loss correctly in the appendix to the tax return but made a mistake in the printed form. Instead of adding the amount actually reducing the tax loss, the tax payer deducted it and thus increased the tax loss. This error was realised only during the tax inspection, with the administrator assessing a penalty on the difference. The Court did not consider the penalty justified in this case. In the opinion of the Court, the tax administrator should have noticed the obvious discrepancy between the additional tax return filed and the tax loss calculation attached to the return and should not have just mechanically taken over the data from the printed additional tax return. Once the taxpayer informed the tax administrator about this error during the tax inspection, the tax administrator should have reflected this in the tax inspection without assessing a penalty on the difference thus identified.

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Unused air tickets – a taxable supply or loss compensation?

The Court of Justice of the European Union addressed the VAT treatment of unused air tickets. Unlike in previous case law, the court came to the conclusion that payments for issued but unused tickets represent payments for provided supplies.

Air France-KLM operates French domestic flights which are subject to output VAT in France. The CJEU dealt with the question whether the company is obliged to pay VAT on the sold but unused air tickets, which expire and are non-refundable (C-250/14 Air France-KLM). The company did not pay VAT on these unused tickets and kept the entire payment, claiming it represented contractual indemnity. Air France-KLM pointed to the conclusions of previous CJEU decision C-277/05 (Sociéte Thermale) which ruled that deposits collected on the reservation of hotel services and retained by the hotelier in the event of cancellation are a compensation for the loss suffered and thus not subject to VAT.

The judgment in respect of the French airline, however, went into the opposite direction. The CJEU came to the conclusion that the company did not suffer any loss and the amounts representing the price of the air tickets are thus subject to VAT. The CJEU presented the following arguments:

- The company in fact provides passengers with the right to use the domestic transportation service, irrespective of whether passengers actually exercise this right.
- Customers always pay the full ticket price, which is retained by the company in full even if passengers do not board the respective flight; the company basically incurs no loss.
- According to its contractual terms and conditions, the company reserves the right to resell an unoccupied seat to another customer.

If the company "reclassifies" the payment for an air ticket from a consideration for taxable supply to a contractual indemnity, then the payment would be higher by the VAT amount than if the transportation service was actually used by the passenger. This would then be devoid of any economic sense. In the case of Hop!-Brit Air SAS (C-289/14), the CJEU's conclusion was similar, as it ruled that commission for sold air tickets represents payment for a taxable service, irrespective of whether the passenger actually exercises the right to transportation.

In the light of the CJEU's new judgments it may be a good idea to consider the VAT regimes applied in similar cases. Obviously, payments or deposits received for unused services and retained by the provider cannot generally be considered supplies outside the scope of VAT. Instead, one has to always look at the substance of the transaction.

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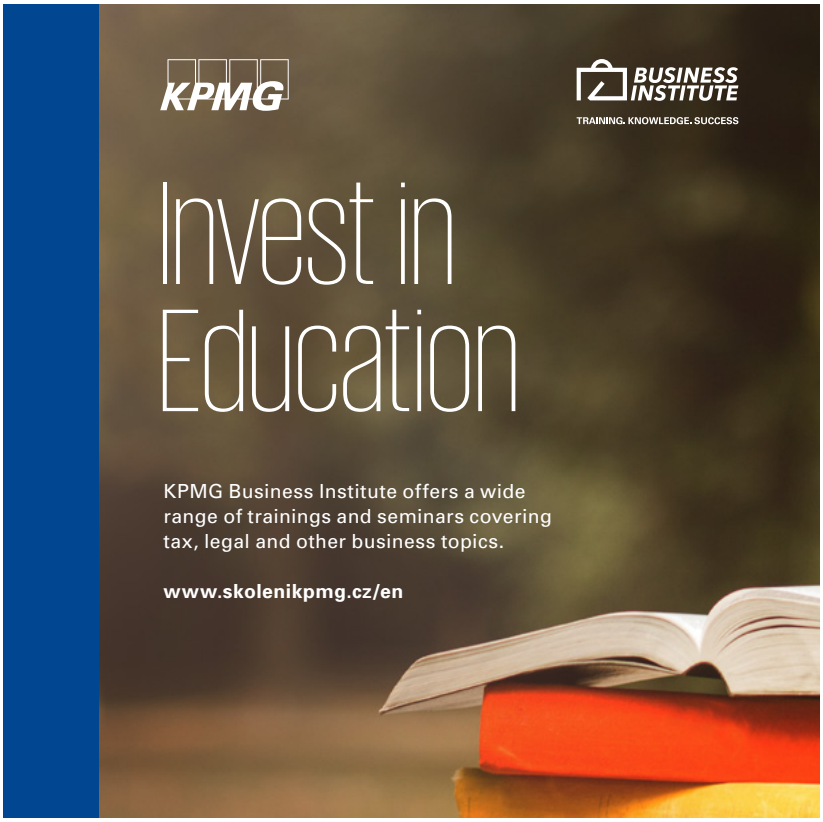
News in brief

- On 28 December 2015, an amendment to the Consumer Protection Act was published in the Collection of Laws. It partially became effective already by its publication, primarily as regards the new regulation of unfair and aggressive business practices, deceitful behaviour and omissions, etc. Effective from 1 February 2016, the amendment newly regulates the out-of-court settlement of consum er disputes which are initiated upon the motion of consumers and for which the Czech Trade Inspection Authority or another special authority (i.e. the Financial Arbitrator, the Czech Telecommunications Authority, or the Energy Regulatory Authority) are competent authorities. Entrepreneurs are also newly obliged to inform consumers in a clear, understandable, and easily accessible manner about the authority competent to settle consumer disputes.
- New Deputy-Minister of Finance Alena Schillerová said in an interview for Ekonom magazine that one of her priorities would be an entirely new Income Taxes Act instead of continuing the series of endless amendments to the Income Taxes Act from 1993. The new Income Taxes Act is to be based on new principles and should not include so many exceptions as the existing ITA which make it look disorganised.
- Effective from 21 May 2016, 23 local tax authorities will move their stored taxpayers' files to other local tax authorities (which are part of the same tax authority). This change follows the GFD's new Guidance No. GFŘ-D-23 on the placement of a file or its relevant part at tax authorities or their regional offices.



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