



Tax and Legal Update

Tax news

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July 2016



Dear readers,

Summer is now in full swing and many of you are enjoying your well-deserved holidays. But not all the Tax and Legal Update's regular authors have taken off and so we may again present you with an issue full of interesting tax and legal news.

Deputies are enjoying their vacation so we have no legislative news. We therefore shifted our focus to tax judicial decisions and conclusions deriving from discussions at the Coordination Committee of the General Financial Directorate and the Chamber of Tax Advisors that may be of interest to you.

Dramatic legislative changes are to be expected from the beginning of 2017. These will involve the launch of the electronic reporting of sales, amendments to tax legislation approved by the government last week, the implementation of cross-border transfer pricing tools as well as the implementation of other initiatives to tackle aggressive tax planning. An interesting time might be ahead of us, as also indicated by an analysis of Brexit impacts on taxes, prepared by KPMG's EU Tax Centre very early after the United Kingdom European Union membership referendum.

May your summer have more warm summer rains than thunderstorms!



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TAX NEWS

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- | Leasehold improvements upon mergers
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- | New call under Operational Programme Employment



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Delay in delivery of goods abroad and related VAT treatment

The Coordination Committee of the Chamber of Tax Advisors and the General Financial Directorate (GFD) discussed a submitter's contribution regarding the delivery of goods abroad during which a delay between the commencement and completion of transit occurs as a result of a temporary suspension of transportation. The coordination committee had to decide whether such an instance involves the delivery of goods to another member state or a third country that is exempt from VAT.

In this particular case, finished goods, i.e. products in the final state required by the customer, were transported out of the Czech Republic. No work was done on these products after they were forwarded and before they were delivered to the customer. However, their transportation was interrupted for logistic reasons and the products had to be stored in another member state while remaining in the ownership of the Czech supplier.

From a VAT perspective, the GFD confirmed that this type of delivery should be considered a single delivery of goods to another member state or a third country (depending on the final place of delivery to the customer) that is exempt from VAT. According to the GFD, the transaction should not be split into the delivery of goods to the country in which goods are temporarily stored and the subsequent delivery to the country of destination. This is in accord with the case law of the Court of Justice of the EU, which held that a taxable supply in form of the delivery of goods to another member state cannot be dependent on the fulfilment of any time limits in which transportation should be commenced or completed (C-84/09, X).



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Leasehold improvements upon mergers

The June Coordination Committee of the Chamber of Tax Advisors and the GFD concluded a long-held debate regarding technical improvements to leased assets after the merger of the lessee and the lessor.

The discussion's outcome provides guidance on how to depreciate and tax technical improvements from the successor company's perspective:

- The GFD clearly rejected the submitters' effort to allow an alternative regime for treating the original assets (usually real property) separately from related technical improvements for tax purposes. After a merger, only a single asset item should be taken into account for tax purposes.
- Upon the merger of the lessee and the lessor, the successor company should increase the cost of an asset (or the tax value of an asset when using the accelerated depreciation method), usually an item of real property, by the tax value of related technical improvements. Afterwards, the successor company – irrespective of whether it is the lessor or the lessee – should continue to depreciate such an asset at the adjusted cost (or the tax value) while using the same depreciation rate or coefficient.
- With respect to the occurrence of non-monetary income as a result of the termination of a lease relationship, the GFD confirmed that no non-monetary income occurs to either party concerned in such situations.



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Proving the origin of assets to tax administrators as a form of punishment

It seems that taxpayers' report cards were deserving of punishment this year: after a year of rigmarole, the chamber of deputies passed the draft Act on Proving the Origin of Assets. The act allows tax administrators to call upon taxpayers to prove the origin of income relating to an increase in their assets, consumption or expenditures. If a taxpayer fails to conclusively prove the income, additional tax will be assessed, followed by a penalty, and a request to declare assets. Should taxpayers fail to submit the declaration of assets or provide false or grossly misstated data, they face up to three years in prison.

Tax administrators may call upon taxpayers to prove their income if they have any doubt whether the income stated by the taxpayer corresponds to the increase in the taxpayers' assets, consumption or other expenditures. The difference between the asserted income and the expenditures must, in the tax administrator's opinion, exceed CZK 7 000 000. If a taxpayer receives the call, they are obliged to prove facts regarding the relation between their income and expenditures in the "relevant period" or prove that such facts occurred at a time since when the period for determining tax has already elapsed. This means that, in response to the call, taxpayers namely have to prove that:

- their expenditures were covered by the income received in the relevant period as determined by the tax administrator (for instance by tax-exempt income); or
- were covered by income received more than three years ago.

If the taxpayer fails to prove this, the tax administrators shall proceed to assess additional tax. The tax administration will first try to determine the tax based on its own evidence proceeding. If no such proceeding is possible, the tax administrator shall estimate the amount of the taxpayer's income. The estimate of income shall be carried out in a specific manner, using the tools stipulated by law (such as available information, financial ratios, comparison against comparable taxpayers); this manner of determining tax involves a higher penalty (equal to 50 or 100 % of the tax determined using the tools). If the tax administrator has no sufficient information to estimate the income for the purpose of tax calculation, they may call upon the taxpayer to declare their assets, provided that the aggregate amount of assets that the taxpayer has to declare is expected to exceed CZK 10 000 000. It may not be always easy for the taxpayer to carry the burden of proof – and sanctions may be considerable; it is therefore appropriate to make sure that records of all income are kept properly (or initiate their review).



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New call under Operational Programme Employment

The objective of the new Corporate Employee Education call under the Operational Programme Employment is to increase the level of professional knowledge, skills and competencies of workers and to improve the adaptability of older employees. Applicants may also include large businesses. Below, we summarise the most important information:

Financial aid

- total allocation for the programme: CZK 1 500 000 000;
- amount of support per one project: **a minimum of TCZK 500, a maximum of MZCK 10;**
- co-financing rates: the maximum rate of support per one project is 50% (block exemption regime) – **85 % (de minimis regime) of total eligible costs;**
- eligible costs in the programme are based on unit costs; this means that the amount of support is not linked to the amount of funds actually spent as per accounting records.

Most important conditions of the call

- applications accepted from: **1 July 2016 (4:00 a.m.) to 31 August 2016 (5:00 p. m.);**
- public aid regimes: de minimis or block exemption for education; combination of the mentioned aid regimes within a single project is not possible;
- time of project implementation: for de minimis, implementation not earlier than 15 June 2016; for block exemption, implementation may start after the application deadline;
- length of project: 24 months, with the latest date of completion of physical implementation on 30 April 2019;
- supported activities (education areas): general IT, soft managerial skills, language training, specialised IT, accounting, economics and legal courses, technical and other professional training, internal language assistants/lecturers;
- activities that cannot be covered: electronic training, safety and health protection on the job, fire safety, first aid training, drivers' training, training of clerks and similar training courses stipulated by a binding national standard of education;
- place of implementation: Czech Republic with the exception of Prague;
- target group: employees in a labour-law (employment) or a similar relationship with the applicant's organisation, except for persons employed under agreements to complete a job.

For further information, visit the website of the [European Social Fund of the Czech Republic](#). We will be happy to assist you in preparing a project application.



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Personal data protection

- new regulation from 2018

After years of preparations, the European Parliament and the Council passed the General Regulation on Personal Data Protection to enter into effect on 25 May 2018, revoking the current Directive of 1995 and the Czech Personal Data Protection Act. Although it may now seem that the effective date is still far away, the new regulation is not to be underestimated and the preparations for the changes should not be delayed.

Unlike today, personal data protection will be truly unified, as the regulation is directly applicable in all EU member states. This has been called for in particular by personal data administrators and processors, who had to struggle with various rules regulating the area despite it being harmonised by the mentioned directive; the directive, however is rather dated and has not been keeping up with the rapid developments of digital technologies over the more than twenty years since its adoption.

The uniformity principle is also demonstrated through the establishment of the European Data Protection Board, which should unify the practices of national supervisory authorities. A benefit for the administrators will be the concept of a "lead supervisory authority", thanks to which administrators and processors will be able to communicate primarily with a single authority instead of separate ones in every state. From the perspective of data subjects (meaning us as individuals), technological developments are reflected by new rights. These include a right to erasure (also referred to as the 'right to be forgotten') which has already been partly deduced by the Court of Justice of the EU under the current regulation, and the right to data portability (for instance if you wish to transfer your profile and history from one social network to another).

The principles of personal data protection remain unchanged. Processing should still take place primarily upon the consent of the data subject. The definition of personal data has been broadened to include genetic and biometric data. The regulation clearly emphasises profiling, which has to be attended to by processors dealing with increasingly popular Big Data. For entities who process personal data systematically, the regulation introduces the duty to carry out an impact assessment prior to processing, to set appropriate mechanisms and safeguards already when designing the system of processing (protection by design) or to appoint a data protection officer (an analogy of compliance for handling personal data). The general duty to report any processing to a supervisory authority has been abolished, but the regulation introduces a duty to report any security incidents (typically unauthorised access to personal data, theft, etc.) without delay.

Cross-border transfers of personal data have not changed substantially, while the regulation may, under certain conditions, also affect personal data processors outside the EU. Enforcement of the new rules is provided for by a considerable increase in sanctions for their breach (up to EUR 20 million or 4% of the worldwide annual turnover). This is another reason not to leave the implementation of any changes until the last minute, but to initiate a review of legal and technical setup of the personal data processing system in time.



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Two new bills to protect whistle-blowers

Disunity in the governmental coalition has also become apparent in the legislative area. Ministers for ANO and ČSSD prepared two competing draft acts to protect whistle-blowers, i.e. employees who report their employers' illegal conduct. Both acts aim to protect whistle-blowers from an employer's reprisal. This is an entirely new concept not yet regulated by Czech law.

Both bills are identical as to the definition of persons to be protected from reprisals: employees in both private and governmental sectors, soldiers and members of security forces. Yet, the means of achieving this goal differ.

The proposal of Andrej Babiš already exists in a wording broken down by individual sections. Special treatment should be granted to persons who report that their employer, colleague or member of the employer's statutory body has, in connection with the employers' activity, probably committed one of the crimes listed in the act; these include namely corruption crimes, tax-related crimes, fraud, and crimes involving public contracts. Subsequently, the employee may apply for protected informer status. If obtained, the employer will need the consent of the labour office before undertaking any actions against whistle-blower (in particular termination of employment). And, should any such unlawful harm to whistle-blowers actually occur, the Ministry of Finance shall compensate them for the loss of earnings, if any. Employees will also be able to use an alternative form of protection – by anonymously informing on the commission of a crime, using a platform administered by the prosecuting attorney's office, the establishment of which the draft act also assumes.

Jiří Dienstbier has so far presented his vision only as a draft/paper. According to his proposal, it is necessary to encourage those who report any unlawful acts of their employers, not just crimes. However, the manner of protection has not yet been clearly formulated, while two options are being considered: one of them is enacting an explicit ban of any unlawful sanctions against those who have reported an employer's illegal activities, while the employers would be discouraged from breaching the ban by the threat of penalty by Labour Inspection Office. Under the second option, reporting of an employer's unlawful act would be classified as one of the prohibited reasons under the Anti-Discrimination Act; employees facing reprisals could then sue their employers under this law.

It is not yet clear which of the proposals will succeed. The only thing that both authors agree on is that the opposing concept is unsatisfactory and that the act should be passed in their proposed wording instead. The government has so far skirted the situation by taking a neutral standpoint to the draft act submitted by Andrej Babiš.



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Commission to prepare a legislative proposal for generalised reverse charge

The Economic and Financial Affairs Council (ECOFIN) at its June session dealt with the issue of fighting tax evasion in the area of direct and indirect tax. Within its session, the Commission submitted an analysis of the possible application of a generalised reverse charge mechanism in Austria and in the Czech Republic. The introduction of a generalised reverse charge is conditional upon a change to the current EU VAT legislation, which limits the application of reverse charge to specific, high-risk areas.

In response to the political consensus regarding the council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (Anti-Tax Avoidance Directive – ATAD), the Commission undertook to submit, by the end of the year, a legislative proposal that would allow individual member states to divert from the common VAT system so as to apply the reverse charge mechanism to domestic supplies in excess of a defined limit.

According to the Czech finance minister, VAT collection by means of reverse charge, together with introducing VAT ledger statements, is the most suitable tool to address tax fraud in the VAT area. The intention of the Czech Republic is to allow the introduction of this mechanism for domestic supplies in excess of EUR 10000.



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The finance ministers within the Economic and Financial Affairs Council (ECOFIN) agreed on the wording of the directive that, together with the OECD's recommendations, introduces specific measures against aggressive tax planning.

The final wording of the directive contains most of the measures proposed by the commission, while some provisions have been moderated in favour of taxpayers. Below we summarise the individual areas of taxation addressed by the directive:

- **Limiting the tax deduction of costs of debt financing** (not just interest expenses) – this is the most significant measure within the ATAD Directive. Net financial costs (financial expenses exceeding financial revenues) should be tax deductible only up to 30% of EBITDA; for the purpose of this measure, it should be calculated as the company's earnings before tax, increased by depreciation/amortisation and the difference between financial expenses and financial revenues. Member states may decide that interest up to EUR 3 million will be tax-deductible regardless of the EBITDA criterion. This means that the limitation of the tax deductibility will be general, applying to both intra-group and third party financing. Under certain conditions, the directive allows for the deduction of costs of financing in excess of 30% of EBITDA where the debt ratio of a specific company is the same as the ratio on the group level. This measure should not apply to companies that are not a part of a consolidation group. Member states may also stipulate that the limitation shall not apply to financial institutions.
- **Exit taxation** – the ATAD Directive introduces taxation of unrealised gains in cross-border relocations of assets between a company and its permanent establishment, and in changes of a tax domicile.
- **General anti-abuse rule in corporate income taxation** – for the purposes of calculating corporate income tax, tax-motivated transactions with no real economic substance shall not be considered.
- **CFC rules** – the ATAD Directive introduces rules under which profits of a controlled foreign company may be, under certain conditions, taxed within the tax base of the parent company, without profits actually being paid. The rules shall only apply to certain types of mainly passive income, such as interest, dividend or royalties, and income from financial activities.
- **Hybrid mismatches** – the directive contains rules restricting the tax use of structures profiting from the mismatch between the legislations of individual states. Double deductions of the same interest expense or a tax deduction of a payment without the same payment being taxed by its recipient should no longer be possible.

The directive has to yet be formally approved by the European Council, however, its wording should not change. The directive should be implemented into Czech law by the end of 2018, with the new measures (with certain exception) to enter into effect on 1 January 2019. The directive leaves a considerable discretion to the member states as to how the individual provisions will be regulated. In particular, where the national legislation already contains rules against base erosion and profit shifting that are as effective as the limitation of tax-deductibility of interest, the member states may postpone the implementation of this specific measure until the OECD agreement in the this area.



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Courts stand up for taxpayers in transfer-pricing cases

For some time now, tax administrators have been extremely busy with transfer pricing inspections. As a rule, they assess additional tax by challenging the taxpayer's functional and risk profile or by pointing out the existence of group relations constituting the group's obligation to compensate local entities' losses. This approach by the tax authorities has been questioned in several recent judgements.

In one of the cases, the tax administrator assessed the arm's-length character of prices at which a Czech manufacturer sold its products to its parent company to be distributed in foreign markets. In the period under review, the manufacturer incurred an operating loss. The tax authority concluded that, with respect to the company's functional and risk profile of a contract manufacturer, the loss should be compensated by the parent company. The tax administrator prepared several comparative analyses, which were, however, showing methodological deficiencies (for instance the exclusion of companies with a negative EBIT, failure to carry out proper quantitative analysis). The tax authority also disregarded any objections as to the specific conditions and economic circumstances, such as the weather which had a major effect on the demand for the company's products.

The regional court confirmed that the tax authority erred in preparing the comparative analyses. In the situation where it was not possible to find a sufficient sample of comparable uncontrolled companies, it was, in the court's opinion, appropriate to examine the other part of the transaction (i.e. to test the profitability of the parent company as the distributor). As for the manufacturer's functional and risk profile, the regional court concluded that the classification of entities as contract manufacturers or full-fledged manufacturer is only a model classification; what is important is the analysis of the entities' actual behaviour, which should be taken as the most conclusive evidence supporting the actual risk distributions.

In another case, the tax authority assessed additional tax for a company that supplied to a significant customer – an unrelated party – at a loss. In the tax administrator's opinion, this was initiated on the group level, where the sale of the products by the Czech company at a loss allowed the group to supply other products to the same customer at a profit. According to the tax authority, the arrangement involved a kind of service provided by the Czech company to the group, for which it should have been compensated. The tax authority then assessed additional tax on this fictitious revenue. The regional court repealed the tax administrator's decision. In its opinion the tax authority failed to prove that the prices of products were set at the group level without any influence of the Czech company, and that the group as a whole profited from trading with the given customer.



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Both judgements show that in cases like these, it may be worthwhile to stand up to the tax administrators' incorrect approach to transfer pricing. Effective arguments can often be found in the procedural area – tax authorities still frequently err in evidence proceedings and do not respect the distribution of the burden of proof as stipulated by law. These deficiencies are usually enough for the court to rule in favour of the taxpayers.



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Abuse of law by postponing due date of receivables

Recently, we were able to view a new “piece” on the Czech case law stage, where tax administrators, again, resorted to their increasingly popular tool – the abuse of law concept. This time, the agreements on postponing the due date of debts were reviewed by the Regional Court in Prague, which in turn passed a stern decision.

The case in question started in 1999 and 2000 when members (individuals) of a limited liability company concluded with the company a lease of non-residential premises and a contract on the sale of tangible fixed assets and goods for millions of Czech crowns. By an agreement dated 2005, the due date of all members' receivables arising from the rent was postponed to the end of 2020. By an agreement of 31 December 2008, the due date of receivables from the sale goods and tangible fixed assets was also postponed, to the same date. However, within a 2008 tax inspection, the tax administrator assessed additional tax on all unpaid liabilities of the company to its members that became statute-barred in 2008 and before or where more than 36 months had elapsed from their original due date. It thus disregarded both the mentioned agreements of 2005 and 2008.

The tax administrator explicitly designated the agreement of 2005 as abuse of law. By concluding the agreement, the due date of the rent receivables was postponed for up to 20 years (even where the corresponding debts were already statute-barred). Such arrangement, in the tax administrator's opinion, does not correspond to economically rational reasons pursued by independent entities. According to the tax administrator, the tax advantage thus obtained consisted in the fact that the company could claim the rent as its tax-deductible expense in individual years, while the members did not receive any rental payments, therefore did not tax any corresponding income. By postponing the due date of the liabilities arising from the purchase of tangible fixed assets and goods, the company gained a considerable advantage in connection with a substantial reduction in the tax rate between 1999 and 2009. According to the tax administrator, by concluding the mentioned agreements the company tried to bypass the legal regulation stipulating the duty to tax past due liabilities.

The Regional Court in Prague confirmed the tax administrator's approach. In contrast, the conduct by the company and its members was subjected to crushing criticism: the court did not go along with the company's assertions that the purpose of postponing the due date was to leave the funds to the company for further investments and development. In the regional court's opinion, the company had enough cash and funds available in the years in question, even enough to provide an interest-free loan to its business partner; had the purpose been to provide the company with extra funds, this could have been done for instance by granting a loan or a credit or by making a contribution to the registered capital.

The case has now been referred to a critic most qualified: the Supreme Administrative Court. We shall thus have to wait for a couple of months for the final verdict.



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Is the "good faith" concept spilling over into other tax areas?

In its recent judgement, the Supreme Administrative Court (SAC) dealt again with an evergreen on the Czech tax scene – tax fraud. A highly specific ruling suggests that the good faith concept, and the "should have known" test known from the VAT case law regarding carousel fraud may also apply in other taxation areas.

The recent SAC judgement in case 4 Afs 23/2016, despite being very specific, operates rather dangerously with the principles formulated in the case law on VAT fraud, and the concept of good faith. In their argumentation, courts had been considering the possibility of applying the same principles in the area of income tax that permit removal of the entitlement to VAT deduction in a situation where a VAT payer knew, or should have known, that they were receiving a supply affected by a fraud. The SAC concluded that this principle shall be applied not only for VAT purposes, but must be respected generally, also when assessing tax-deductible expenses for the purpose of income tax.

In the case in question, the SAC dealt with the tax deductibility of expenses incurred on construction work carried out by individuals (Ukrainian workers) where remuneration was paid in cash. There was no dispute between the parties as to whether the construction work had actually been carried out. The primary issue was proving the remuneration as an expense. The problem was that the cash receipts accounted for were issued by companies that did not have any employees at the time, and, moreover, were uncontactable. The SAC first endorsed the use of the above described concept formulated in the VAT case law and aimed at carousel fraud. However, eventually it expressed the legal opinion that, although the plaintiff could not have been in good faith, they must be given a chance to prove that the expenses were incurred in the declared amount even if the construction work had been carried out by someone else than the companies given in the receipts.

The case, and the conclusions of the court, are of a highly specific nature. However, the question is whether they may suggest a new trend – being harbingers of the application of the concepts formulated for VAT fraud to other taxes as well.



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Postponed due dates and liability for VAT

By postponing the date on which the purchase price must be paid, may sellers intentionally evoke a situation in which they are incapable to pay tax, thereby giving rise to the buyer's liability for VAT? This was an issue recently discussed by the Supreme Administrative Court.

In recent Judgment No. 4 Afs 294/2015, the SAC had to decide on the sale of a technological part of a photovoltaic power plant by a company subject to insolvency proceedings. The buyer and the seller mutually agreed to postpone the date on which the purchase price would be paid until the moment on which the seller's licence to generate electricity would be cancelled and the buyer's licence would be extended. Since the seller did not pay the major part of the billed VAT, the tax authority claimed the remaining unpaid VAT from the buyer on the grounds of the liability for VAT. The tax authority argued that the seller had intentionally put himself into the situation in which he would not be able to pay VAT.

As in its previous judgments, the SAC again noted that intent in this case may either be direct or indirect. A person acting with indirect intent is a person who knows what they may cause and, should it happen, accepts the consequences. In this particular case, when the technological part of the photovoltaic power plant was sold and the purchase price had been agreed not to be settled before the transfer of relevant licences, the SAC decided that it must have been clear that the seller would not have sufficient funds to pay VAT applicable to this sale.

Also, according to the SAC, the fact that the seller was subject to insolvency proceedings was not at all a decisive factor for meeting the conditions for the origination of a liability for VAT. Decisive was that the provider of the taxable supply at issue did not have sufficient funds to pay VAT as a result of an agreement to postpone the payment of the purchase price, based on which the tax authority may have concluded that the seller intentionally put himself into a situation in which he was unable to pay VAT. We therefore recommend paying proper attention to invoices with longer due dates and to the related issue of a liability for VAT.



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In brief

- The Ministry of Finance is considering the postponement of the electronic reporting of sales, to be launched on 1 December 2016 and applicable first to businesses providing accommodation and meal services. However, the launch may only be postponed by one month to 1 January 2017 as the ministry is concerned with a potentially higher error rate that may occur because of the holiday season. The ministry is also currently dealing with a large number of requests for granting exceptions and alterations submitted by e-shops, stallholders, etc. The ministry should decide about the postponement by the end of August.
- The government approved several draft amendments to tax legislation effective from 2017, to be discussed in short in our August Tax and Legal Update. The Ministry of Finance's press release in Czech is available at the following [link](#).
- The GFD published Instruction D-28 on the waiver of penalties for the failure to report exempt incomes.
- The government approved an amendment to the Act on State Social Aid, which should help improve the work-life balance, according to the Ministry of Labour and Social Affairs. A more flexible regulation will allow parents to choose the amount and duration of their parental allowance based on their current situation.
- A protocol to amend the double-taxation treaty between the Czech Republic and Kazakhstan entered into force on 28 June 2016. The protocol, amending a number of the treaty articles from 1998, will be effective from January 2017.



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