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Introduction by Pavel Rochowanski

Dear readers,

It is hard not to notice how busy everybody gets at this time of the year – both at work and on the home front. Accountants are getting ready for financial closings; managers are planning their financial goals for the coming year; and even the construction sector is running at full blast, needing to use up all those public funds. And, on top of all that, gardens and weekend houses have to be winterized and prepared for the harsh weather that's predicted.

The activity of public bodies, both national and international, may also be likened to garden work under the code name "hunt the mole" – ideally so that he won't show up next year or at least abandon his underground economy runs. Several instruction manuals have already been written about Czech VAT pest control tools, including VAT ledger statements and electronic reporting of sales. In this issue, we will introduce to you some of the European innovations in this field, about to be implemented in our legislation sooner or later.

Following the Fourth AML Directive, the Ministry of Finance has submitted to the government an amendment to the Act on Certain Measures against Legalisation of Proceeds from Crime and Terrorist Financing. The amendment, among others, provides a more precise beneficial owner definition and stipulates a new duty to register them in public registers. The OECD recommends unifying national regulations in the field of hybrid mismatch arrangements, controlled foreign companies or patent box tax regimes.

The European Commission has also kept busy, investigating tax regimes of certain multinationals and being not too shy to request information from other states, the companies in question, or their competitors – surely, there is nothing like healthy rivalry! The VAT area cannot go unnoticed either – here, we focus on the possibility of breaking through the national limitation period for the prosecution of VAT-related offences if a criminal court of a member state concludes that such a period does not provide sufficient protection to the fiscal interests of the EU. Finally, we include at least one judgement where the Supreme Administrative Court stood up for the taxpayer – protecting honest taxpayers from being liable for their uncontactable suppliers. All's well that ends well. I sincerely hope that our update will nicely shorten at least one of your long November evenings.

Pavel Rochowanski
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End of restructuring in the CR?

Last week the Supreme Administrative Court published its long-awaited decision regarding the application of the abuse of law concept to intra-company reorganisations. The court examined the deductibility of interest on a loan provided by a related party for the purpose of financing the purchase of ownership interests in companies acquired from this related party.

The decision involved the merger of a creditor with the acquired companies, as a result of which the taxable profit generated by the successor company from its business activities was reduced by the interest expense associated with the loan drawn for the acquisition. Simultaneously, the "Czech" part of the restructuring was the part of the group reorganisation consisting of several phases, one of which was the establishment of a financing and holding arrangement in the Netherlands and Luxemburg. This new organisational scheme involved hybrid financing, i.e. interest on a loan was treated as deductible in one country and, simultaneously, as tax-exempt dividend in the country in which the interest was received.

In this particular case, the SAC agreed with the tax authority's conclusions about the abuse of a right to claim interest on the loan in question. In its reasoning, the court further elaborated that it does not in general dispute methods of financing via debt or the possibility to acquire ownership interests to carry out a subsequent merger. The court nevertheless emphasised that such transactions *must be made for clear economic and justifiable reasons and not just for tax purposes*. It is therefore not surprising that a substantial part of the SAC's decision was primarily dedicated to examining the economic grounds of the intra-company transaction at issue. The court found the reasons presented by the taxpayer neither sufficient nor economically or rationally justifiable. According to the SAC, the restructuring in question did not lead to a change in the overall ownership structure, a new acquisition, the integration of management or to the reduction of operating expenses. The court was of the opinion that the merger resulted in the indebtedness of a thriving business without any economic grounds. Other facts, such as the conditions for the drawing of the loan, only helped the court further realise that there were no sufficient economic but mainly tax reasons for the restructuring. The court also held that, in the context of the abuse of a right to deduct interest for tax purposes, the compliance with thin capitalisation rules claimed by the Czech entity may only be relevant in the case of economically justifiable intra-group financing.

The court's decision further confirms the tax administration's tendency to examine intra-company restructuring processes in more detail. It is quite obvious that it is necessary to assess all associated risks and carefully document proper and economic reasons before undertaking any reorganisation.

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Green light to old age savings

While proceeding with its plan to terminate the Pillar 2 pension scheme, the government is also planning to increase tax support for other old age pension insurance products.

In accordance with a government draft amendment to the Income Tax Act currently discussed in the Chamber of Deputies, pensions paid out over a minimum period of ten years via the majority of pension products ought to be exempt from income tax from 2016. It has so far been possible to exempt from tax only the pensions for which a pay-out period had not been set. The planned change has already raised interpretation doubts regarding the application of this exemption in practice. It is not, for example, clear whether the pension pay-out period has to be set beforehand as fixed and unchanging or whether the actual fact that a pension has been paid out for at least ten years will suffice. The question of whether or not an exemption from tax should be applied with respect to individual clients will be quite vital for institutions that pay out pensions and are actually responsible for their correct taxation.

The government also proposes changing the limit for claiming tax exemptions regarding employers' contributions to pension products from CZK 30 thousand to CZK 50 thousand a year. Similarly, limits for deductions from the tax base should increase two-fold to CZK 24 thousand. This applies to both supplementary pension insurance, the Pillar 3 pension scheme and private life assurance. If taxpayers make use of all these incentives, they will be able to save an additional CZK 44 thousand compared to what they may save now.

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Nine pitfalls of VAT ledger statements

VAT ledger statements are about to be launched. What areas deserve special attention? Below we summarise the most problematic ones.

An interface for XML file testing

According to the GFD, an interface for the testing of software for the generation of VAT ledger statements will not be disclosed sooner than at the beginning of December.

Application of a five-day deadline

A five-day deadline to respond to a call from the tax authority has been introduced along with the VAT ledger statement duty; the same limit shall apply to submitting a subsequent VAT ledger statement. Attention should be paid to different definitions of these deadlines: to react to a call from the tax authority, the five-day limit involves five calendar days; to file a subsequent VAT ledger statement, the five-day limit includes five workdays.

ID data boxes vs. e-mail addresses

The tax administrator plans to communicate with the taxpayer either via a data box or via e-mail if the taxpayer does not have a data box. Each communication channel has special delivery effects. When sending messages by e-mail, the delivery date will be the date the e-mail is sent by the tax authority. This option may turn out to be quite impractical.

Submitting a zero VAT ledger statement

According to preliminary information, it will be possible to file a zero VAT ledger statement only after the tax authority calls on the taxpayer to confirm that the taxpayer's duty to file a VAT ledger statement has not really arisen. However, to avoid any potential sanctions, we recommend filing zero VAT ledger statements also in periods in which you do not carry out any transactions which have to be included in VAT ledger statements. The financial administration promised that the submitted zero VAT ledger statements will be accepted.

Tax document number

Both the supplier and the customer must state the same tax document number set by the supplier, including all alphanumeric characters. Beware that some accounting systems may not accept anything else but numeric characters.

Tax documents with different types of taxable supplies

According to preliminary information, a limit of CZK 10 thousand (incl. tax) will decide whether a transaction will be reported in A.4 or A.5, or B.2 or B.3. It seems that the limit should concern only the value of a taxable supply. If one tax document includes a supply that is taxable as well as a supply that is exempt from tax, only the taxable supply's value should thus be decisive for reporting purposes. The correct treatment is, however, still discussed with the tax authority.

Summary tax documents

If a summary tax document includes taxable supplies for a period longer than one month, these taxable supplies should be reported in two VAT ledger statements immediately following one another. The limit of CZK 10 thousand (incl. tax) should then be considered with respect to the total of supplies included in the summary tax document for each individual taxable period separately.

Correction of internal accounting entries

Internal corrections of accounting entries that do not affect customers, relevant tax documents or relevant taxable supplies should not be reflected in VAT ledger statements. If they are reflected there, there is a risk that the given transaction will not match the taxable supply reported by the relevant business partner. In such cases, the tax administrator will issue automatic calls.

Corrective tax documents – credit notes

The issue of corrective tax documents where the date on which the duty to report the correction varies for the supplier and the customer remains unresolved. It is not obvious what date will be used to match the corrections for both parties.

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Accounting and tax outsourcing may be worthwhile for statutory bodies

Members of statutory bodies of corporations have the duty to exercise their offices with due care and are liable for any damage the corporation may incur as a result of a breach of this duty. This liability also covers the duty to maintain accounting records and tax compliance. Recently, the Supreme Court confirmed that statutory bodies act with due care even when assigning the task of maintaining the company's accounts and filing its tax return to a qualified entity.

The case in question involved accounting for a receivable from a member of a limited liability company. The member claimed the receivable to be non-existent, and argued that the company's executive was liable for damage caused by recording this purportedly non-existent receivable in the company's accounts and including it in the income tax base. General courts did no find the executive liable, since, by appointing a qualified entity to keep the company's accounts as well as a tax advisor to supervise the entity, he had acted with due care. These conclusions were subsequently also confirmed by the Constitutional Court.

The Supreme Court judgements in this case provide a general summary of the further duties of statutory bodies ensuing in connection with assigning the task of maintaining the company's accounts to another entity: in doing so, the statutory bodies have the duty to check whether such entity is qualified, to establish conditions for exercising its office, and, last but not least, to effectively supervise the exercising of the task thus entrusted.

This does not mean that executives or board members may fully relieve themselves from their duties by assigning their corporation's accounting to another entity; however, provided that certain preconditions are met, it may help limit the statutory bodies' liability for damage incurred as a result of incorrect accounting. The same should also apply to assigning tax matters to tax advisors.

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AML and registration of beneficiary owners

As a consequence of a European regulation, an amendment to anti-money-laundering and public registers legislation is underway. It should involve the obligatory registration of the beneficiary owners of legal entities and trusts. Other changes will affect the process of client checks by liable entities, the definition of which is to be extended. The regulation of virtual currencies is also being prepared.

Following the Fourth AML Directive (Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing), the Ministry of Finance has submitted to the government a draft amendment to Act No. 253/2008 Coll., on certain measures against legalisation of proceeds from crime and terrorist financing (the AML Act).

The present wording of the AML Act already contains the definition of a beneficial owner: for an entrepreneur, it is an individual exercising directly or indirectly controlling influence; holding (alone or with others, under agreement or concert) more than 25% of voting rights; or receiving entrepreneurial proceeds on other grounds. A similar definition applies to beneficial owners of foundations and associations. The proposed amendment now adds the definition of who is deemed to be a beneficial owner of a trust: i.e. the founder, trustee, beneficiary, a person exercising supervision or control, a person in whose interest the trust has been established or is operating, or the person exercising the supreme managerial office.

Yet, the most important change concerns the Act on Public Registers. Under the proposed amendment, the following data of the beneficial owners will be recorded in a public register: name and surname, birth date, citizenship (fully public information), as well as the reason why the person is deemed to be a beneficial owner (private information). The full extract from the register, including this information, will be available, upon request, to courts and other stipulated entities. According to the Financial Analysis Unit (FAÚ), the data will be recorded directly in the Commercial Register.

Other changes intended by the proposed amendment include the transformation of the Financial Analysis Unit (currently a part of the Ministry of Finance) into an independent Financial Analysis Authority, the reduction of the limit for entrepreneurs as "obliged entities" from EUR 15 000 to EUR 10 000 for cash transactions, the extension of the definition of obliged entities to also include operators of lotteries and entities providing services connected with virtual currencies (bitcoin), and a new regulation of the process of checks on politically exposed persons.

The Fourth AML Directive was adopted in May of this year and is to be transposed into Czech law within two years. The proposed amendment now awaiting discussion by the government should become effective from 1 July 2016; the part concerning beneficial owners from 1 January 2017.

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OECD recommends unifying national rules

The OECD presented its final package of measures within the BEPS Action Plan. The implementation of these recommendations may well mean the end of the "tax world" as we know it. BEPS is divided into three main pillars, which we will cover in a series of articles. Today, we will focus on recommendations in the area of unification of domestic regulations.

Hybrid mismatch arrangements

Hybrid mismatch arrangements involve situations where certain transactions are treated differently by the national legislations of contractual states, resulting in double non-taxation or double deduction. For instance, a certain payment may be treated as a tax-deductible expense by a subsidiary, while on the part of the parent company it may be tax-exempt as a profit distribution. Within this Action the OECD recommends introducing domestic legislation (or amending the existing one) to the effect that hybrid mismatch arrangements would not bring any benefit to taxpayers. It is expected that the proposed rules will be implemented extensively: for instance, the tax exemption of certain types of income may in the future be conditional upon the non-tax deductibility of the payments in the country of the payer. Multinationals should thus consider whether their structures contain certain special-purpose transactions or entities falling under the proposed rules.

CFC rules

A number of countries have implemented Controlled Foreign Company (CFC) regimes to tackle aggressive tax planning via establishing subsidiaries in countries with low taxation. Within BEPS Action 3, the OECD provides a framework and tool for the implementation of effective CFC regimes in countries where they have not been implemented yet.

Financing – tax deductibility of interest

BEPS Action 4 focuses on the application of a net interest/EBITDA ratio, introducing a significant change from the existing thin capitalisation rules. According to OECD recommendations, the net interest/EBITDA ratio should be between 10 and 30%; interest in excess of the stipulated limit would not be tax deductible. All interest and similar payments, including those paid to independent entities, are to be combined for purposes of the tax deductibility test. The introduction of this rule will mean the need to revise existing financing setups and the capital structures of subsidiaries.

Harmful tax practices

BEPS Action 5 aims to identify preferential regimes that are "misused" by multinational groups for tax optimisation. One of these practices is using IP or patent boxes based in countries with preferential tax regimes. Companies place their intangible assets (patents, etc.) and related income into such IP boxes, while these hollow entities do not actually contribute to the generation and development of such assets. Action 5, among others, makes using such preferential regimes conditional upon carrying out a substantial activity in the development of such intangible assets, and recommends introducing the automatic exchange of information on awarding such regimes. Some multinationals may thus be forced to revise their structures based on using the IP regime.

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EC: Luxembourgian and Dutch selective tax advantages ruled illegal

According to a decision by the European Commission, Luxembourg's and the Netherlands' granting of selective tax advantages to Fiat and Starbucks is contrary to the European rules on granting public support.

Both rulings in question were issued by the governments of Luxembourg and the Netherlands in accordance with national legal regulations; from this perspective, they are legal. However, as the Commission argued, both support artificial and rather complex methods of determining the corporate income tax base of the companies: they do not reflect economic reality, and the approved manner of setting transfer prices between related parties within the group does not comply with the arm's-length principle; therefore, from the perspective of state aid regulations, they are illegal. According to the Commission, tax administrators in their rulings cannot use transfer pricing methods that would lead to an excessive reduction of taxable profits and their shifting into countries with low or zero taxation. This would create an unfair competitive advantage against other businesses, in particular small and medium-sized ones. The Commission thus ordered the governments of Luxembourg and the Netherlands to recover EUR 20 to 30 million from the companies, and to repeal the rulings. Both governments announced that they will appeal the Commission's decision.

The European Commission continues its investigation into further cases, involving e.g. Belgium and Ireland (Apple, Amazon). It has started using information request tools under Regulation 734/2013, which allows the Commission to request additional information within its state aid investigations from other member states and also directly from the company involved and its competitors. Another tool is being prepared: a directive on the automatic exchange of information on advance tax rulings (DAC III); its draft was approved by ECOFIN (Council of EU finance ministers) in October. The detailed wording is to be completed by the end of this year and member states should transpose the DAC III directive into their national legislations by the end of 2016.

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Punishment for VAT crimes scrutinised by the EU

In September, the Court of Justice of the EU gave the national criminal courts a free hand to decide on the length of VAT crime prosecution.

The Court of Justice had to respond to a question raised by an Italian penal court. The penal court was concerned that owing to the complexity of a case involving a group of companies committing VAT fraud its decision would not enter into legal force before the end of the limitation period prescribed by Italian criminal legislation (C-105/14). The Court of Justice held that under such specific circumstances the member states' criminal courts may break the intrastate limitation periods for VAT fraud prosecution if they believe that the prescribed period does not sufficiently and effectively protect the EU's fiscal interests. The Court of Justice emphasised that the intrastate penal court may break the limitation period based on its own decision after taking into account the specifics of a particular case. The penal courts neither need to ask any higher courts, including the Court of Justice, nor do they have to wait for a legislative change.

The Court of Justice's decision derives from the member states' duty to impose effective and deterrent sanctions to protect the EU's fiscal interests embedded in the Treaty on the Functioning of the European Union and the VAT Directive. Parts of revenues generated by individual member states from VAT form an important source of the EU budget. The decision might also be applicable in criminal proceedings whose subject-matter is the protection of other EU budget sources such as customs or EU budget expenses such as subsidies.

The question is how the extension of the limitation period for criminal prosecution would be viewed by the judges of the Czech Constitutional Court. Their previous decisions indicate that they have left themselves a backdoor to be able to intervene where EU law clashes with the boundaries of the Czech constitution.

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Uncontactable supplier card overtrumped

The Supreme Administrative Court has recently issued a decision in favour of taxpayers. When deciding on the entitlement to VAT deduction, the court did not accept the tax administration's trump card arguing the uncontactability of a supplier.

Within VAT-related inspections the Czech tax administration has recently shown an increased tendency to argue the uncontactability of a supplier, especially where it relates to chain selling. In practice it is difficult, sometimes even verging on impossible, for companies to anticipate some of their suppliers being, according to the tax administration, "uncontactable" sometime in the future.

The tax authorities are generally imposing increasingly demanding and highly detailed requirements on taxpayers regarding the examination of their suppliers. These requirements often go beyond the scope of publicly available information. The SAC did not agree with the tax administration's tendency to proceed in this manner and in recent Decision No. 5 Afs 180/2014 stood up for taxpayers. The court unambiguously declared that the uncontactability of a supplier who had existed at the time of a sale or a purchase, continued to exist and was filing corporate income tax returns, cannot be assessed retrospectively and cannot automatically prejudice the supply recipient.

This particular case involved the purchase of a steel structure from a disassembled hall. It was in principle clear that the taxpayer had really acquired the steel structure at issue and had subsequently resold it, but witnesses did not remember any details and their testimony was very vague. The fact that the payment for the steel structure had not been deposited directly to the supplier's account further deteriorated the taxpayer's position. According to the tax authority, the taxpayer did not prove that the purchase had been carried out as reported in invoices and thus failed to meet the conditions to claim the entitlement to VAT deduction. This was further confirmed by the first-instance court.

The SAC expressed a different opinion, emphasising that the entitlement to VAT deduction is a basic right of the taxpayer embedded in the very nature of the tax system, despite the formal restrictions applicable to tax documents. The SAC also highlighted that the tax administration may not demand the substantiation of facts relating to other persons, i.e. suppliers, from taxpayers. It is also worth mentioning that the supplier in question was an existing legal entity whose taxes should have been administered by the appropriate tax authority. According to the SAC judges, the uncontactability of such a supplier during a tax inspection performed three years after the delivery of goods cannot prejudice the taxpayer.

We can only hope that this helpful approach adopted by the SAC towards honest taxpayers will beat the existing trump card of the tax administration when dealing with the entitlement to VAT deduction. Hopefully, this will not be the last indication of a shift in the strictness of the courts' interpretations.

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News in brief

- Notice of the Ministry of Labour and Social Affairs No. 272/2015 Coll., prescribing the reduction limits to adjust daily assessment bases for sickness insurance in 2016, was published in the Collection of Laws.
- The European Commission has opened a public consultation with the aim to identify ways to simplify the rules for VAT payments on cross-border e-commerce transactions within the EU.
- The government has submitted to the Chamber of Deputies an amendment to the Act on Immovable Property Acquisition Tax, which is planned to become effective from 1 April 2016.
- The Ministry of Finance announced that a double taxation treaty between the CR and Pakistan entered into force on 30 October 2015. The treaty will be effective from 1 January 2016 in the CR and from 1 July 2016 in Pakistan.