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12

2015

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Introduction by Václav Baňka

Dear readers,

In this issue of Financial and Tax Update we are bringing you further information on the BEPS Action Plan – an initiative of the Organisation for Economic Cooperation and Development (OECD). It is yet to be seen how and when the conclusions of the Action Plan will be reflected in Czech legislation.

It can be expected that countries will be weighing the benefits of the individual actions for their budgets against reducing their ability to compete – which may be a side effect of the changes. Some of the actions are solely recommendations, while some, and they are not few, are binding upon the countries. The actions mentioned in today's issue fall under those that will be addressed by international treaties or their interpretations (OECD Transfer Pricing Guidelines, OECD Model Tax Convention). Of course, they are also expected to have an effect on national legislations. As it would be complicated to amend hundreds of bilateral double tax treaties, the involved countries have agreed on adopting a multilateral treaty – an instrument to modify all bilateral treaties.

The development of such an instrument is the subject of the last action, Action 15, and we will keep you informed about progress in this area as well. Approximately 90 countries are involved in the preparation and negotiation of the instrument, with its completion planned for 2016. Please also note that some of the actions may be implemented into Czech legislation through EU legislation, as the EU intends to address some of the areas of the OECD Action Plan simultaneously through directives. In the near future we are thus likely to see significant changes in international taxation and transfer pricing, as well as an effort for the gradual harmonisation of direct taxes at the EU level.

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Nine changes in employee taxation in 2016

Below, we summarise information for employers on how to correctly proceed with the taxation of their employees next year. The government has promised additional support to families with children; will we get to see it?

Personal income tax

- The 15% personal income tax rate on the super-gross salary and the 7% solidarity tax surcharge will remain applicable. The solidarity tax surcharge will have to be paid from incomes exceeding an increased monthly limit of CZK 108 024. The annual limit will amount to CZK 1 296 288.
- Employers will be allowed to carry out the year-end tax settlement for 2015 on behalf of employees whose incomes do not exceed CZK 1 277 328 for the year, even if these employees paid the solidarity tax surcharge in some months, provided that other specific criteria prescribed by law are met.
- Employers will also be allowed to carry out the year-end tax settlement for employees who have to submit statements of tax-exempt income exceeding CZK 5 million for the first time in 2015, provided that other specific criteria prescribed by law are met.
- The Pillar 2 pension scheme will quite certainly be abolished. Employers should thus make final payments to the Pillar 2 pension scheme relating to December 2015 in January 2016.
- The minimum wage will increase to CZK 9 900 a month. The tax credit for placing a child into pre-school facilities will also increase. However, the definition of a potential provider of childcare services will be stricter.
- The government's draft amendment to the Income Tax Act increases the tax credit for the second child to CZK 17 004 and the third and any next children to CZK 20 604. As the parliament is unlikely to approve the amendment before the end of this year, it will be possible to claim the higher tax credit for the months preceding the amendment's adoption within the year-end tax settlement for 2016.

Social security and health insurance

- The maximum assessment base for social insurance premiums in 2016 will be CZK 1 296 288.
- Just as previous years, 2016 will also not see a maximum assessment base for health insurance.
- The minimum required amount of the monthly health insurance premium will be CZK 1 337 (to be calculated from the increased minimum wage of CZK 9 900).

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Immovable property acquisition tax to be paid by the acquirer

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An amendment to the Act on Immovable Property Acquisition Tax to enter into effect on 1 April 2016 has been submitted to the Chamber of Deputies by the government. The amendment finally repeals the possibility of choosing the payer of this tax. Under the new regulations, it will always be the acquirer who will pay the tax in all circumstances. The amendment thus abolishes the concept of the other party's liability for unpaid immovable property acquisition tax.

The amendment also introduces other changes. Any extension of the ownership right to the superficiary right to construct will also be considered an acquisition of the right of ownership liable to immovable property acquisition tax. The amendment sets the duration of the exemption from tax relating to the acquisition of the title to constructions for five years from the earlier of the date on which a permit to use the construction was issued or the date on which the construction was used for the first time. Under the new amendment, the tax exemption will not apply to transfers of unfinished or partially built real property. Owing to ambiguities in assessing the nature of the utilities infrastructure, only the acquisition of buildings that are part of the utilities infrastructure will be taxed.

On the exchange of real property, the amendment simplifies cases where taxpayers choose a reference value as their comparable tax value. Reference values derive from prices of similar immovable items in a given time and place, taking into account their type, location, purpose, condition, age, facilities and technical parameters. Under the new amendment, it will no longer be necessary to determine the value of the immovable property being exchanged. The contracted price will therefore be 100% of the reference value or the value determined by an independent expert. Where a reference value is used, immovable property acquisition tax prepayments will only be paid from potential payments made in addition to the exchange of property.

In addition, the amendment extends the scope of legal persons that will not be liable to immovable property acquisition tax on transformations. The tax exemption has so far only been applicable to transformations of corporations; from now on it will also cover associations and foundations. However, the exemption will not apply to corporate transformations in form of transfers of assets and liabilities to shareholders. According to the amendment's transitory provision, tax liabilities originating before the effective date of this amendment will be treated in compliance with the existing wording of the act.

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Controversial taxation of revaluation reserve distribution

The professional public opened a Pandora's Box early this year, asking the tax administration a question concerning payments made from the components of equity, in particular from revaluation reserves on transformations. It is not surprising that, owing to the controversial nature of this topic, discussions taking more than half a year did not result in any consensus.

At their November meeting, the Coordination Committee of the Chamber of Tax Advisors and the General Financial Directorate ended their heated discussions regarding revaluation reserve distribution. The committee discussed a hypothetical situation in which the successor company, after the merger of two Czech companies, reports revaluation reserves in equity that are subsequently paid out to parent companies seated in the EU.

Opinions on how to tax payments made from components of equity, the source of which were revaluation reserves in the past, varied considerably. Part of the professional public, including those submitting this topic for discussion, believed that revaluation reserves de facto represent future profits of a subsidiary making this distribution, i.e. these payments may be treated as "pre-paid profit shares". If the criteria of a parent-subsidiary relationship are met, such payments could be considered exempt from tax. The General Financial Directorate, however, did not agree with this and presented its views on this subject, which can be summarised as follows:

- The accounting recognition of payments made from the components of equity at the time of payment is not decisive for determining a tax regime. What matters is the civil-law title that gives rise to the source of paid-out funds.
- The distribution of revaluation reserves on transformations cannot be regarded as the distribution of shares of profit and thus cannot be exempt from tax.
- Income of a corporation's member deriving from paid-out revaluation reserves will be subject to withholding tax (15% for Czech residents). For taxation purposes, it will be possible to decrease this income by the cost of the acquired share in the corporation making the respective payments.

The GFD also expressed its opinion on the distribution of revaluation reserves to non-residents in the CR, in particular:

- Such payments represent income from sources in the CR (other income from holding equity investments) liable to withholding tax. The tax base for withholding tax can be reduced by the cost of the acquired share.
- Where a double-taxation treaty applies and if the wording of this treaty complies with the OECD's Model Tax Convention, Article 10 – Dividends is usually applicable.
- If the reduced rate of withholding tax is applied under the respective double-taxation treaty, it is not possible to decrease the tax base by the cost of the acquired share.

The professional public and the tax administration did not come to an agreement. The positive outcome is, however, that we may at least deduce how the tax authorities are likely to proceed when examining the tax treatment of payments made from these specific components of equity.

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Quicker visa application process for Ukrainian specialists

On 9 November the government approved a pilot project aiming to accelerate the process of attending to applications for work permits designed for highly qualified personnel from Ukraine.

Ukrainians currently applying for a visa to the CR have to go through a very lengthy process. Owing to the restricted number of dates on which it is possible to apply for a visa via the VisaPoint system (i.e. the Ministry of Foreign Affairs' internet portal for application registration), it may take months to make an appointment to submit a visa application.

A new *Special Procedures for Highly Qualified Ukrainian Personnel* programme was launched by the government in November. The programme aims to accelerate the process of accepting and settling applications for employment cards (Blue Cards) designed for specialists and highly qualified personnel from Ukraine. The government is thus allowing up to 500 Ukrainian technical specialists per year simplified access to the Czech labour market. Jobs can be assigned to Ukrainians if the required specialists are unavailable on the Czech labour market but only after a particular vacant job has been recorded with the central register of vacancies. The Ministry of Industry and Trade is the guarantor for accepting applications and enrolment in this programme.

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Friday the 13th – an unlucky day for insurance legislation

The Chamber of Deputies did not pass a package of amendments to insurance legislation aiming, among others, to implement the Solvency II directive, whose transposition deadline is 1 January 2016.

Friday, 13 November 2015 was indeed an unlucky day for the proposed amendment to the insurance act and related laws: It failed to pass through the Chamber of Deputies by just three votes. The rejected package also included an amendment to tax laws responding to the planned changes to insurance legislation.

This also meant the rejection of an amending proposal aiming to limit intermediaries' incentives to conclude life assurance contracts. The amending proposal attempted to curb commission amounts when contracts are terminated early by the policy holders – should this happen within the first five years, the insurance intermediary would only be entitled to a proportionate part of the commission, paid out gradually.

The proposed amendment to the Insurance Act thus follows the fate of the proposed amendment to the Act on Insurance Intermediaries. This amendment was withdrawn during its second reading in July of this year; the government has, however, publicly undertaken to revise it. We expect the amendment to the Insurance Act to be resubmitted in the future, if only because it implements some EU regulations into Czech legislation, among others the Solvency II directive, whose deadline for transposition is 1 January 2016. After this date, the Czech Republic will risk non-transposition sanctions by the European Commission.

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Conferring jurisdiction per mouse click

Between entrepreneurs, it is possible to conclude a valid agreement on the international jurisdiction of a court of an EU member state just by clicking on a hypertext link to general terms and conditions, the Court of Justice of the European Union stated.

Even a standard and obligatory click to agree to general terms and conditions may constitute a valid agreement conferring jurisdiction in written form in the meaning of the Brussels I regulation. This was confirmed by the Court of Justice of the European Union in its recent ruling in case C-322/14, El Majdoub (Judgment C-322/14 of 21 May 2015). According to the CJEU, this practice constitutes click-wrapping, whereby buyers accept general terms and conditions by merely clicking on a link as they may view and print or save the text of the terms and conditions.

An agreement conferring jurisdiction (a prorogation agreement) is regulated by the Council regulation on jurisdiction, recognition and enforcement of judgments in civil and commercial matters (Brussels I regulation). Parties in disputes with international elements may agree that a court of an EU member state where at least one of the parties is domiciled will have jurisdiction over their disputes arising from a particular legal relationship.

On 10 January 2015, the Brussels I regulation was amended leaving out the requirement that at least one of the parties must be domiciled in the state of the exclusive jurisdiction. However, an agreement conferring jurisdiction still has to be concluded in the forms listed, while electronic communication providing a lasting record of the agreement is equivalent to writing. Jurisdiction thus agreed upon is considered exclusive.

Please note that the CJEU judgement probably will not apply to relationships with consumers due to increased consumer protection in respect of distance contracts.

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BEPS recommendations: tax where profits are generated

In the previous issue, we summarised the recommendations of the BEPS Action Plan regarding the unification of domestic legislations. This time, we shall focus on the second pillar of BEPS, i.e. the taxation of profits at the place where value is created. This concept is mainly reflected in BEPS Actions 6 to 10.

Implementation of the individual recommendations within the BEPS Action Plan will take some time. In a number of jurisdictions, some of the recommendations have already been implemented. In 2016, a multilateral instrument implementing selected measures without having to renegotiate valid international treaties is to be developed. Therefore, when planning future transactions, we recommend taking into account opinions published within the BEPS project, as it is expected that the Czech Republic, being an OECD member, will sooner or later implement at least some of the recommendations.

Action 6 Preventing treaty abuse

This action aims to prevent double tax treaty abuse and treaty shopping, which may involve making selected types of payments through intermediaries located in countries where a valid international tax treaty allows for the exemption of income from withholding tax. The OECD proposes two basic rules: a general principal purpose test rule and a specific limitation on benefits rule.

The former assesses the substance of a transaction with the possibility to annul it for tax purposes (this already applies in the United Kingdom); the latter rule focuses on beneficial recipients of payments, with the possibility to deny treaty benefits where recipients are only intermediaries. The two rules, and their combination, should help in determining what is (and what is not) in compliance with the purpose and conditions of respective double tax treaties.

Action Plan 7 Avoidance of permanent establishment status

Action 7 deals with the artificial avoidance of permanent establishment status, e.g. by means of commissionaire arrangements, applying exceptions from the permanent establishment status as per Article 5(4) of the Model Tax Convention (e.g. using representation offices) and splitting up contracts (e.g. for construction work). In its final recommendation, the OECD proposes significant changes to the definition of a permanent establishment – e.g. a change in the definition of a dependent agent: the agent no longer has to directly conclude contracts in the name of an enterprise; it will suffice if the agent plays a leading role in concluding a contract with a customer. This action also addresses the artificial splitting up of contracts between related parties to fit in the time test; this should no longer be possible in the future.

Action Plan 8 - 10: Transfer pricing

Action Plans 8 to 10 aim to assure that transfer pricing outcomes are in line with the economic substance of the activities carried out. Work on these action plans resulted in the extensive modification of the OECD Transfer Pricing Guidelines. Changes to the OECD recommendations will concern mainly the transfer pricing assessment of intangibles, services, specific transactions such as cost sharing or the assessment of contractual risk allocation between related parties. The emphasis is on allocating profits to the countries where value is created.

For intangible assets, the DEMPE analysis is mentioned, assessing where the development, enhancement, maintenance, protection and exploitation of intangible assets takes place. Solely transferring licences to shell entities in tax havens (so called IP boxes) should in light of BEPS no longer be sufficient for allocating income from such licences to these entities.

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The allocation of risks and related profits should be aligned to the location of the functions that manage such risks, possibly also to the capital necessary for their coverage. This is also in line with the approach applied by the Czech tax administration, which, according to its press release of 18 November focuses on "verifying the transfer pricing methodology so as to reflect the actual scope of functions carried out and risks borne by the taxable entity". It may therefore be expected that tax administrators will review in minute detail the functional and risk profiles of contract manufacturers who have for years been reporting losses.

The proposed new wording of Chapter VII of the OECD Guidelines also provides a simplified approach for low value-adding intra-group services (a uniform mark-up of 5%).

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Change in German consignment stock delivery rules

A recent German tax court judgement suggests a change in the approach to the VAT regime of delivering goods through consignment stock located in Germany. Under certain conditions, the supplier may not have to register for VAT in Germany.

Up until now, German legal practice has viewed the delivery of goods from another EU member state to Germany through consignment stocks as two separate supplies: one involving the movement of goods by the supplier from another EU member state to the consignment stock in Germany; and the other consisting of the subsequent local delivery of the goods, involving the duty of the supplier to register for VAT in Germany.

A recent judgement of a tax court in Lower Saxony challenged this practice, admitting that under certain conditions it may be possible to apply a simplification when delivering goods through a consignment stock, and to only report the transaction as an acquisition of goods from another EU member state by the final customer (a similar approach as already applies in the Czech Republic). The supplier thus would not have the duty to register for VAT in Germany. The main condition for applying this approach is concluding an exclusive contract with a specific customer. The German tax administration has not appealed the ruling. The conclusions of the court may be useful when setting-up or revising your commercial transactions in Germany.

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~~Crime~~ and Punishment in Tax

Since February of this year, the Supreme Administrative Court has been keeping us in suspense as to whether a tax penalty has the nature of a punishment. The unravelling of this intricate matter has, surprisingly, almost an American-style happy end.

Because of previously contradictory decisions by various panels of the Supreme Administrative Court, the decision on the nature of tax penalties had to be eventually made by an extended panel of judges. After almost nine months of debates, the panel of seven judges finally issued the unanimous decision that a tax penalty under the Act on Administration of Taxes and Fees and the Tax Procedure Rules has indeed the character of a punishment (Ruling 4 Afs 210/2014-57).

The court bringing up the issue of the nature of a tax penalty had dealt with a company which in the additional assessment of a lower tax loss had under the Act on Administration of Taxes and Fees been prescribed a tax penalty five times higher than under the newer Tax Procedure Rules. The additional assessment only took place after the new Tax Procedure Rules had entered into effect. At the same time, the company could not apply for waiving the penalty as was possible under the older regulation (the Act on Administration of Taxes and Fees); the Tax Procedure Rules did not allow for the waiving of penalties until 2015.
The company invoked a legal principle that is common in criminal law, i.e. that a later law should be applied rather than the one that was in effect at the time when the duty to pay the penalty originated, provided that this is more favourable for the taxpayer.

In this case, the judges were inspired by the case law of the European Court for Human Rights. They also dealt with the nature of the breach of law for which the penalty had been imposed, and the strictness of the penalty. According to the SAC, a tax penalty has a punitive nature, as its purpose is not to compensate for unpaid tax, but to punish the entity and discourage it from similar conduct in the future. The amount of such a penalty should thus be determined according to a later regulation, i.e. the Tax Procedure Rules, at 1% of the amount by which the loss had been reduced, rather than at 5%. At the same time, the extended panel of judges pointed out that with so-called payment delicts it is not always possible to apply all legal principles, especially taking into account specific circumstances, property owned by the taxpayer, etc.

The extended panel of judges included tax penalties under the scope of payment delicts and also mentioned the Constitutional Court's similar conclusion on a penalty for the late filing of a tax return. Inconspicuously, it also suggested that even late payment interest might be viewed as punishment, if its amount is "excessive". This implies, that although the ink of this ruling has not even dried yet, this crime and punishment novel remains to be continued…

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Additional deductions?

The Supreme Administrative Court's recent decision drew attention to the tax administration's principal mission, which is to ascertain and determine tax in a correct and proper manner. And in the light of this, the court allowed the taxpayer apply higher deductible items within its additional income tax return despite the explicit restriction prescribed by the Income Tax Act.

In late summer, the Supreme Administrative Court judges had to issue a decision regarding the case in which a publicly beneficial taxpayer had applied an item decreasing the tax base within an additional income tax return (Decision No. 1 Afs 238/2014-52). The taxpayer declared a lower tax liability in the additional income tax return and therefore was at variance with existing Section 38p of the Income Tax Act ("ITA"). Until the end of 2014, this provision allowed the additional application of deductible items and items decreasing the tax base only when the tax liability had been increased by a minimum of CZK 1 000.

The tax authority discontinued the proceedings held in respect of the submitted additional income tax return. The taxpayer's approach was also entirely dismissed by the first-instance court. The SAC, however, was the first authority which considered the taxpayer's case in its entirety, taking into account that the taxpayer had before unsuccessfully tried to apply the deductible item during the previous tax inspection. Interpretations prevailing at that time, however, did not support the taxpayer's procedure. In the light of its previous case law (especially Decision No. 9 Afs 41/2013-33), the SAC decided to come to the aid of the taxpayer and again highlighted the tax administration's basic principles and mission as defined by the Tax Procedure Rules. The court pointed out that the tax administration's goal is not to collect as much tax as possible, as might be deduced from the abolished Act on Administration of Taxes and Fees preceding the current Tax Procedure Rules, but to ascertain and determine tax in a correct and proper manner. According to the court, controversial Section 38p of ITA should not be regarded as an exception to this key principle of administering taxes.

It should be noted that the mentioned explicit restriction of additionally applied deductions was cancelled effective from 1 January 2015 in response to the SAC's 2014 case law permitting the application of tax losses during tax inspections. Some tax authorities, however, have voiced the opinion that the abolition of Section 38p of ITA can only be applied to additional income tax returns for periods following 2015. The question is whether such a strict interpretation would hold out after the SAC's newest decision. We will only see in practice whether this decision will affect the tax authorities' decision-making process on allowing taxpayers to additionally apply gifts and other deductible items that may have been forgotten.

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How to correctly substantiate advertising costs

Tax authorities have recently focused their inspections not only on the deductibility of advertising costs but also on the substantiation of the actual nature of provided advertising services. In its recent decision, the Supreme Administrative Court emphasised that taxpayers should already at the time of entering into relevant contracts bear in mind that they will have to prove that advertising services have actually been rendered.

In this particular case, the court had to issue a decision regarding the deductibility of advertising costs incurred for an advertising spot broadcasted on large screens and for organising certain advertising and promotional events. The taxpayer claimed that these costs had been incurred in a particular period. Documentation such as the relevant purchase order, invoices, a video and witness testimonies were made available to the tax authority. However, to their disadvantage, the taxpayer did not have a suitable system of control over the broadcasted advertising. Witness testimonies conflicted with respect to the broadcasting times, revealing that the advertising spot could not have been broadcasted because, according to the respective documentation, it had not yet been produced. The tax authority concluded that the invoices themselves did not prove that the relevant costs had been incurred and excluded these costs from the tax base. This conclusion was further confirmed by the SAC in subsequent proceedings. The court pointed out, inter alia, that taxpayers must always clearly prove when and where they acquired their means of evidence.

The question is, however, what may be considered a sufficient means of evidence proving that advertising costs have really been incurred. According to the SAC, also referring to its previous case law, acceptable means of evidence are, for example, testimonies of employees randomly checking that advertising took place or photos proving that advertising was provided at different times and different locations. Another acceptable means of evidence is e-mail correspondence that need not to have been signed with a guaranteed electronic signature.

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CJEU: Non-existing supplier does not nullify purchaser's right to deduct VAT

It is not possible to refuse the entitlement to VAT deduction of a purchaser of fuels on the grounds that Polish legislation considered the supplier to be a non-existing entity, provided that the goods at issue have really been delivered and a relevant tax document issued by the supplier includes all essential elements prescribed by the EU VAT Directive.

Recently, the Court of Justice of the EU discussed the possibility to refuse the entitlement to VAT deduction of a purchaser of fuels on the grounds that Polish legislation considered the supplier to be a non-existing entity. The Polish tax administrator rejected the purchaser's entitlement to VAT deduction on the purchase of fuels from a Polish company. The administrator claimed that according to Polish regulations, the invoices for the purchase of fuels had been issued by a non-existing entity. The decision was affirmed by an appellate tax administration body asserting that the supplying entity was non-existing since it had not registered for VAT, had failed to pay taxes, and had not been licensed to sell fuels.

When adjudicating the case, the Polish Supreme Administrative Court decided to inquire at the CJEU whether goods are deemed to have been supplied if neither the tax administrator nor the purchaser are able to determine the actual supplier of fuels, and also whether the pertaining Polish regulations are in conflict with the EU's VAT Directive. The Polish act in question forbids a person liable to tax to deduct VAT if an invoice has been issued by an entity that is not an actual supplier and as such cannot be forced to pay VAT.

The CJEU considered the criteria for the entitlement to VAT deduction provided for in the VAT Directive in detail and concluded that the respective Polish regulations and the steps taken by the Polish tax administrator were indeed in conflict with the VAT Directive's stipulations. Under the directive, entitlement to VAT deduction is not conditional upon the supplier's authorisation to perform an economic activity. The CJEU further asserted that if all VAT deduction entitlement requirements laid down by the VAT Directive are met, it is neither fair nor justified to require the purchaser to verify whether the supplier has fulfilled the duty to file a VAT return or to pay taxes. Nevertheless, the CJEU concluded that the entitlement to VAT deduction may be rejected if the entity concerned knew or could have known, based on objective facts, that the supply they had accepted involved VAT fraud, whereas it is the responsibility of national judicial bodies to consider whether this had been the case.

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- A Notice of the Ministry of Foreign Affairs on the Double Taxation Income Tax Evasion Prevention Treaty signed between the Czech Republic and the Islamic Republic of Pakistan has been issued under No. 58/2015 of the Collection of International Treaties.
- A Notice of the Ministry of Foreign Affairs, amending the Treaty on the Exchange of Information in Tax Affairs signed between the governments of the Czech Republic and the Cayman Islands and published under No. 90/2013 of the Collection of International Treaties, has been issued under No. 60/2015 Coll.
- A decree on the determination of the basic per diem rates for trips abroad for 2016 has been published in the Collection of Laws under No. 309/2015 Coll.
- The OECD informed on the Global VAT Forum summit, which took place on 5-6 November 2015 and at which governments of over 100 participating countries agreed on the international standard for applying VAT in cross-border transactions: VAT should be paid in the country where the goods are consumed or the services are used.