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Tax and Legal Update - August 2017

# Editorial

For most people, vacations are an occasion for fun with friends and family. But they can also allow for a rebalancing of priorities for the longer term. All of us can certainly benefit from time and space to think about what we do each day, why we do it, and how we can do it better and more efficiently. This applies to those of us in the tax profession as much as to anyone else. The major changes affecting the interface between government and taxpayers, and technological changes in the marketplace in general, mean that whether we like it or not, constant adaptation and skill acquisition is required.

But whether it's spent on fun, reflection or both, here's to an enjoyable remainder of the summer!

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# Stats and facts about the tax administration's 2016 activities

The Czech financial administration has recently released a report on its activities for 2016. It states that tax revenues grew by nearly ten percent year-on-year, thanks to the tax administrators' increased activities in the inspection area. At the same time, the number of appeals against the tax authorities' decisions increased and international cooperation among tax authorities intensified.

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The financial administration has long been proclaiming that it will take a less formal approach to taxpayers. At the same time, it holds that fighting tax evasion will remain its priority. Perhaps this is the reason why VAT is in many ways number one among taxes: the highest number of inspections (approximately 8 000) and procedures to remove doubts, the highest amount of additionally assessed tax and the highest number of appeals filed. Of the total reported excess deductions, whose amount dropped by nearly CZK 12 billion year-on-year, tax authorities retained nearly CZK 4.7 billion in 2016. The second tax runner up, following individual income tax, was corporate income tax, where additionally assessed tax solely on the grounds of transfer pricing amounted to CZK 886 million, and reductions of tax losses to CZK 8.5 billion.

To make tax collection more efficient, the tax administration increasingly often resorted to various international information exchange and cooperation tools. Close cooperation took place in particular with Slovakia, Poland, Austria, the U.S., and Russia or Ukraine, and recently also with the British Virgin Islands.

In 2016, procedures to review tax liabilities (procedures to remove doubt and tax inspections) took longer and resulted in additionally assessed tax in approximately half of the cases. On average, the amount of additionally assessed tax per tax inspection was approximately CZK 800 thousand. In total, more than CZK 14.5 billion was additionally assessed and tax losses were reduced by nearly 10 billion. Also, tax troubles do not always end with issuing an order to pay the tax, a penalty and a late payment interest: in some cases, the tax authorities also refer the matter to the law enforcement authorities; in 2016, this was done 1 376 times.

Those who hesitate get fined. Penalties for late tax assertions soared to an impressive CZK 372 million. The state budget also received more than CZK 88 million in penalties for the failure to file VAT ledger statements.

The opinions of the Appellate Financial Directorate (AFD) and of the tax authorities have become more closely aligned: last year, the AFD granted only less than one third of appeals. The number of appeals relating to tax on immovable property grew dynamically in 2016. Nevertheless, tax-related disputes often end up in court, where powers are more balanced. More often than not, as to the size of the disputed amount, courts side with the taxpayers rather than with the AFD; penalties for breaches of budgetary discipline are the only exception from this trend.

Thanks to more harmonised legal regulations and closer ties between tax administrations within and outside the European Union, we may expect an increase in both the number and the duration of tax administration reviews. And although judging by the number of dismissed appeals the effort may seem futile, the courts' decisions indicate that to persevere may be worthwhile.

# Legal electronic system for entrepreneurs

The Chamber of Deputies is currently discussing a draft amendment to the Act on the Czech Chamber of Commerce. The amendment also introduces the Legal Electronic System (LES). Aiming to make the business environment in the Czech Republic more transparent, LES will accumulate all entrepreneurs' duties on a single web portal and present them in an accessible format.

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The main reason for the creation of LES is the unorganised, hard to understand and constantly changing legal framework for conducting business in the Czech Republic. LES should help overcome these obstacles by giving entrepreneurs a chance to carry out a simple check of what specific duties they have, how to comply with them, and what sanctions may follow if they fail to do so.

According to the draft amendment, the rather complex system will cover duties arising from existing regulations as well as those associated with new ones. The draft itself already contains a list of legal regulations that the government should evaluate by the end of 2018 to prepare a list of respective duties to be entered into LES; a list of the remaining regulations is to be created by the end of 2022. When drafting legal regulations in the future it will be obligatory to attach to the bills a list of newly proposed legal duties. The draft amendment under discussion also contains a provision that bans the authorities from imposing sanctions for the failure to meet duties that have not been listed in the attachments to the respective legal regulation; this makes the system even more efficient.

LES will be administered by the Czech Chamber of Commerce, which will be given the necessary authorisations for this purpose: for instance the right to obtain data from the register of persons. Based on the information obtained from the register of persons, LES will provide each entrepreneur with information tailored to their needs and business activities. The draft amendment expects the annual fee for using LES not to exceed CZK 1 000.

The draft amendment introducing LES has been submitted by deputies across the political spectrum, therefore we expect it to be passed even after the autumn elections to the Chamber of Deputies. From an entrepreneurial perspective, the actual look of the web portal, the accessibility of the system, and the inherent reduction of the administrative burden will be the most important aspects.

# Constitutional Court puts a brake on the right to information

The right to information, protected by the Charter of Fundamental Rights and Freedoms and further elaborated on in the Act on Free Access to Information and some other laws, is one of the evergreens of administrative justice. The Supreme Administrative Court (SAC) has been construing the right rather extensively: it has also included some business companies among those obliged to provide information. In a rather controversial decision, the Constitutional Court recently challenged this opinion.

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For public administration to function properly, the public must have control over its activity. This idea forms the foundation for the regulation of the right to information. The Act on Free Access to Information (No. 106/1999), among others things imposes a duty on liable entities to provide information on their activity upon request. Exceptions are strictly defined: they include trade secrets and data to be kept secret under the law. The sore spot of the act is the definition of liable entities. Unsurprisingly, these include municipalities and administrative authorities. Yet, they also include 'public institutions' – and this ambiguous term has been interpreted by courts to also cover some business companies: for instance Dopravní podnik hl. m. Prahy (Prague public transport company) or Brněnské komunikace (Brno road network company).

In June, the Constitutional Court ruled on a constitutional complaint by ČEZ, a Czech electricity company, on whom the SAC had imposed a duty to disclose to an applicant a part of its documentation on the operation of the Temelín nuclear power plant. The SAC repeatedly held ČEZ to be a liable entity, in particular with respect to ČEZ being controlled by the state (the state's share of voting rights being approximately 70%). Also, by operating the electricity grid, ČEZ was carrying out an activity in the public interest.

The Constitutional Court, however, did not share the SAC's opinion. According to the Constitutional Court, although ČEZ meets some characteristics of a public institution, it is fundamentally a private law entity, a typical business company. Considering the gross interference in the entity's rights that its inclusion under liable entities under the Act entails, it must be carefully assessed whether its public or private nature prevails. The extent of the state's equity participation is the sticking point here: in the most controversial part of its judgement, the Constitutional Court held that an entity could only be viewed as a liable entity if the state or other liable entities are its sole shareholders. The provision of information is a heavy burden and creates a disadvantage in economic competition. A business corporation can only be burdened by such an obligation if its economic consequences are borne solely by the state (municipality, other public institution). If this is not the case, private entities (i.e. the shareholders) end up carrying the burden, which the Constitutional Court considers inacceptable.

A pessimistic conclusion drawn by a considerable portion of the media is that should any public entity wish to conceal what is happening in their corporations, they only have to transfer a single share to a friendly individual to avoid the status of a liable entity. At first sight, the Constitutional Court judgement may indeed seem to indicate this. We can but hope that the courts will view such a practice as a misuse of a right and will not take such 'transfers' into consideration when assessing the right to information.

# OECD releases draft update of Model Tax Convention

The OECD Committee on Fiscal Affairs has just released a draft update of the OECD Model Tax Convention. Neither the Committee on Fiscal Affairs nor the OECD Council have yet approved the update, but some significant parts have already been sanctioned and published as part of the BEPS Action Plan. The released draft does not necessarily reflect the final views of the OECD and its member countries, as it will only be submitted for approval in the second half of 2017.

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At this time, the OECD has invited the professional public to comment only with respect to those parts of the update that have not been approved as part of the BEPS Action Plan. Three of them involve changes to the Commentary, one involves the body of the Convention.

Two changes to the Commentary are proposed for Article 4, regulating the residence of an individual taxpayer (further clarification of the terms 'permanent home available to' and 'habitual abode'); the third one is an addition to the Commentary on Article 5, indicating that a registration for the purposes of a value added tax or other turnover tax is, by itself, irrelevant for the purposes of the application and interpretation of the permanent establishment definition. The only change in the body of the Convention is the deletion of the parenthetical reference '(other than a partnership)' from Article 10 Dividends, referring to the company receiving dividends; the change follows the more detailed specification in Article 1 of the Convention as regards transparent entities.

Comments on the above changes should be submitted by 10 August 2017 to taxtreaties@oecd.org.

Please note that the 2017 update contains a number of changes and amendments previously approved within the BEPS Action Plan. These include in particular: neutralising the effects of hybrid mismatch arrangements, preventing the avoidance of permanent establishment status, and a mutual agreement and arbitration procedure.

# 2017 OECD Transfer Pricing Guidelines

On 10 July 2017, the long awaited 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 Transfer Pricing Guidelines) were released. The new edition counting 612 pages replaces the previous Transfer Pricing Guidelines issued in 2010 (2010 Transfer Pricing Guidelines) and provides new guidance on the application of the arm's length principle.

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The 2017 Transfer Pricing Guidelines are intended to be a revision and compilation of previous reports published by the OECD addressing transfer pricing and other related tax issues. It reflects the outcomes of the OECD's Base Erosion and Profit Shifting Project (BEPS) and includes revised guidance on safe harbours. Many consistency changes have been incorporated to produce a more consolidated version of the OECD Transfer Pricing Guidelines.

The main changes of the new 2017 OECD Transfer Pricing Guidelines can be found in the following areas:

- intangibles (newly defined categories, functions, risks and so called DEMPE analysis);
- low value adding intragroup services;
- transfer pricing documentation (a three-tiered approach, i.e. master files, local files and country-by -country reporting);
- application of arm's length principle;
- comparability factors in transfer pricing, including location savings, assembled workforce and multinational group synergies;
- cost contribution arrangements and their expected benefits.

OECD is continuously working on the transfer pricing area to improve guidance in all necessary areas such as hard-to-value intangibles and the transactional profit split method. It also aims to identify new areas that need to be addressed. Therefore, further guidance can be expected.

The Czech Republic has followed the OECD Guidelines on Transfer Pricing and it is expected that local regulations, namely instructions issued by the Ministry of Finance, will be updated to reflect the release of the 2017 Transfer Pricing Guidelines.

Case law

# Tax administrators obliged to continuously review conditions for securing tax

An order to secure tax (a securing order) issued by a tax administrator should not be permanent or irreversible. The taxpayers themselves may contribute to its end. At the same time, tax administrators have the duty to regularly review the continuance of the conditions for the securing order; if they fail to do so, procedural consequences may follow.


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A securing order is an instrument the financial administration uses to secure tax that is not yet due or assessed. Recently, it has employed this tool all too frequently. The length of time (duration) of the securing orders has also been criticised by both the taxpayers and the professional public. Although tax administrators usually justify the high frequency of securing orders by their fight against tax evasion, the decision-making practice of the Supreme Administrative Court has now corrected this approach to some degree.

In its recent judgement (No. 1 Afs 88/2017) the SAC first noted, yet again, that a securing order is a rather drastic measure that may have a significant effect on taxpayers' property and, in some cases, their very existence. The court then dealt with justifying the length of time for which tax may thus be secured. It stated that a tax security's extended duration in itself may not be sufficient to conclude that securing the tax had not been justified. According to the SAC, the duration, and possibly the termination of the security always depend on the concrete reasons for which the securing order had been issued in the first place. Taxpayers affected by a securing order have the option to prove to the tax administrator that the reasons for securing the tax no longer exist, or that their relevance has weakened. In this respect, the tax administrator has the duty to review whether the conditions for the existence of the securing order, as stipulated by law, are still being met. Proving the effect of the securing order on the taxpayer's economic activity also plays an important role.

Considering the fatal consequences that securing orders may have, the SAC concluded that over the entire duration of the securing order, tax administrators have the duty to periodically review whether the reasons for securing tax still exist and to note the results of such reviews in their files. In other words, tax administrators are obliged to continuously review whether the statutory conditions for the issuance/existence of the securing order are still being met. If such conditions no longer exist, the tax administrators have to terminate the effectiveness of their decision to secure tax.

# Regional court says no to the concurrence of liability for VAT and denying the entitlement to deduction

The tax administration has numerous tools to fight VAT fraud and evasion, including denying the entitlement to VAT deduction or instating customers' liability for VAT not paid by their suppliers. And tax administrators do not hesitate to use these tools concurrently, thus, in the final effect, collecting tax twice on the same transaction. Czech courts are now dealing with the admissibility of such practice.

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Wherever customers could have known that they received a supply affected by VAT fraud, the VAT Act does not explicitly prohibit applying customer's liability for tax not paid by the supplier and at the same time denying the entitlement to deduct VAT. The Appellate Financial Directorate believes that the customer's liability for unpaid VAT and denying the entitlement to VAT deduction are not mutually exclusive; in its opinion, these are two separate duties arising from different reasons and based on different provisions of the law. Thus, the tax administrator may request the taxpayer to pay the VAT instead of their supplier. Subsequently, the administrator may also issue a securing order for tax not yet assessed, corresponding to the denied entitlement to VAT deduction, on the grounds that the taxpayer could have known that they were involved in VAT fraud.

The Regional Court in Ostrava now looked into this issue more closely. It sided with the taxpayer, clearly rejecting the possibility of paying tax twice on the same transaction. In its justification, the court pointed out the neutral character of VAT, which is meant to tax concrete goods with a tax to be eventually paid by the final consumer. The purpose of the tools and instruments to prevent tax evasion is to ensure that one and the same tax is properly collected for the state budget. The court held that it was inacceptable for one entity to pay VAT twice on an identical business transaction. Unsurprisingly, the Appellate Financial Directorate filed a cassation complaint against the decision, which means that the case will be dealt with by the Supreme Administrative Court. We will yet have to wait for its decision in the matter.

Case law

# SAC: VAT not a part of immovable property acquisition tax base

The Supreme Administrative Court (SAC) in its recent judgement surprisingly diverged from the explanatory report on the Senate's Statutory Measure on the Tax on Acquisition of Immovable Property. According to the report, the agreed-upon price for real property acquisitions means the total price, including VAT. The SAC's judgement now opens up the possibility to file an additional tax return to reclaim part of the tax on the acquisition of immovable property.


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In 2015, the municipality of Střelské Hoštice sold a plot of land by a purchase agreement with an agreed-upon purchase price including VAT. In its immovable property acquisition tax return, the municipality stated the amount excluding VAT as the tax base. The tax administrator challenged this approach and assessed additional tax based on the purchase price including VAT. This tax administrator's approach was then also confirmed by the regional court.

According to the relevant legal regulation, the Senate's Statutory Measure No. 340/2013 Coll., effective 1 January 2014, the subject of the tax on the acquisition of immovable property is the acquisition of an ownership right to real property for consideration. The explanatory report on the statutory measure explicitly states that the agreed-upon price means the total price, including VAT. This definition of the tax base was also taken as a basis by the tax administrator and the regional court.

The municipality, however, referred to the Act on Inheritance, Gift and Real Property Transfer Tax as the legal predecessor of the mentioned statutory measure, and to related case law. According to these, the real property transfer tax should apply solely to the financial revenue itself, not to the VAT being paid to the state budget.

The SAC sided with the taxpayer. It concluded that the VAT should not be included in the tax base of the immovable property acquisition tax. The purpose of the tax on acquisition of immovable property is to tax the financial revenue acquired as a result of a sale of a real property, and VAT cannot be deemed a part of such revenue. Moreover, including it in the tax base would mean taxing amounts that are being collected for the state. The procedure would also be contrary to the tax neutrality principle: for VAT payers, the immovable property acquisition tax would be higher than for other comparable entities that are not VAT payers.

The SAC then dealt with the explanatory report, by stating that the Senate had failed to carry out its intention to include the VAT in the tax base in a clear and undisputable manner. Furthermore, the court admitted that a change of a legal regulation does not rule out the use of case law relating to the previous legal regulation, in particular where it is analogous. The SAC also recognised the existence of two interpretations of the legal regulation and, following the principle 'in doubt in favour of a private entity' sided with the interpretation that VAT was not a part of the immovable property acquisition tax.

The judgement makes it possible for VAT payers to file additional tax returns for immovable property acquisition tax and claim a refund of a part of the tax paid.

# Lafata scores against tax authorities

The Supreme Administrative Court reversed a lower court's decision on the taxation of the Czech football player David Lafata's income. The SAC granted his arguments that a professional football career may be viewed as a trade. This hence should include being allowed to claim expenses as a percentage of income in the amount applicable to traders (a more advantageous percentage than the one applicable to liberal professions).

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Last year, the Regional Court in České Budějovice held that the football player may indeed tax his income as a self-employed person (an individual carrying out an independent gainful activity). However, the court considered his activity a liberal profession, where 40% of income can be claimed as expenses, not a trade, where the percentage of income to be claimed as expenses is 60%. The court based its decision mainly on its assessment of the independence criterion, which was not met, as the football player was active in one club only.

Following this adverse judgement, the football player filed a cassation complaint, arguing the discrimination of athletes pursuing collective sports – as those pursuing individual sports commonly tax their income as income from trade. He also pointed out that the tax administrator has never challenged his accounting for VAT, while carrying out an independent economic activity was a necessary precondition for applying VAT.

In its decision, the Supreme Administrative Court first referred to its previous rulings, in which it held that professional sports involved activities of such an ambiguous and uncodified nature that they may indeed be carried out both as employment (under an employment contract) and as an independent gainful activity. The SAC then elaborated in detail on the individual aspects of the activity. It concluded that while the independence of professional football players was limited, in some aspects it clearly defied the characteristics of dependent work under the Labour Code. Similarly, it was not "purely" an activity carried out in one's own name and on one's own responsibility. Anyway, according to the court, the applicable legal regulations allow the activity of professional athletes to be carried out as a trade, and in the given case, a proper trade licence had been obtained. The court thus did not consider it appropriate to force taxpayers to choose a manner of carrying out their business that would be more advantageous for the state. The SAC also accepted Lafata's arguments regarding VAT registration: in the court's opinion, the tax administrator thus implicitly confirmed that the taxpayer's activity had been carried out independently, in his own name and on his own responsibility.

After reversing the lower court's judgment and the tax administrator's previous rulings, the matter has now been remanded to the Appellate Financial Directorate. In the meantime, the tax administration has issued a statement to the effect that it will align its practice in the taxation of team athletes' income with this judgement. Affected athletes – traders may assert their claims by means of additional tax returns.

# Possible defence against prejudiced expert witnesses

The Supreme Administrative Court (SAC) previously ruled that if the tax administration doubts the nature of activities for claiming an allowance for research and development, it should obtain an expert's opinion. In the court's view, only an expert is able to adequately assess the nature of the activities. But what if the tax administrator appoints an expert who taxpayers deem to be prejudiced? SAC judgement 1 No. 10 Afs 128/2016-68 suggests a possible defence.

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The recent SAC judgement is yet another decision in a pending dispute between a taxpayer and a tax administrator regarding the entitlement to an allowance for research and development. The tax administrator had been obliged to appoint an expert witness with a sufficient expertise able to determine whether the activities carried out by the taxpayer qualified as research and development.

The taxpayer objected that the appointed expert held a managerial position with the taxpayer's direct business competitors, which gave rise to serious doubts as to the expert's objectiveness. At the same time, the taxpayer was concerned that their know-how and production or trade secret may be revealed and possibly misused, with a possible consequence of irreparable harm. The tax administrator rejected the taxpayer's complaint and did not exclude the expert from the tax proceedings. The taxpayer contested the decision by an administrative action filed with the regional court. The regional court held the action inadmissible; in its view, an administrative action could only be used to contest a decision on the merits of the case, not a (merely procedural) decision not to exclude an expert.

The SAC disagreed with this conclusion, stating that an expert's activity involves obtaining detailed knowledge of production plants and processes to properly assess whether elements of novelty and technical uncertainty are present. In the case in question, reasonable doubt existed as to the expert's objectiveness, and the taxpayer's right to the protection of their business and trade secret could potentially be breached. The SAC thus concluded that in situations where a taxpayer's constitutionally protected rights could potentially be breached by the very act of an expert carrying out an assessment, an action against the decision not to exclude such expert is indeed admissible.

# Latest news - August 2017

Last month's tax and legal news in a few sentences.

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- The Ministry of Industry and Trade decided to terminate the acceptance of applications for support under the current call within the Energy Saving programme as of 31 October 2017; originally, the call should have been open until March 2018. The reason for the early termination is the low interest of applicants. At the same time, a new call is being prepared under the programme, to be announced by the end of November 2017. The ministry plans to increase the share in the total allocation earmarked for large enterprises to 60% (from an existing 20%).

- Amendment to the Construction Code (No. 225/2017 Coll.) effective from January of next year was published in the Collection of Laws.

- On 15 August 2017, an amendment to the Act of Foreigners' Residence (published under No. 222/2017 Coll.) will enter into effect, introducing, among other things, a residency permit for investment purposes.

- On 14 July 2017, an amendment to the Employment Act, Labour Code, Labour Inspection Act and other legal regulations was promulgated under No. 206/2017 Coll. It brings changes in particular in the area of non-discrimination, agency employment, job applicants' gainful activity and inability to work, and substitute supplies; it also defines new offences that may be committed by individuals and legal entities (misdemeanours and administrative delicts).

- The new Act on Citizen Identity Cards (No. 195/2017 Coll.) will enter into effect on 1 July 2018. The president also signed a related law, the Act on Electronic Identification (Print No. 1069); it codifies, for instance, the rules for using ID cards with a chip, in line with EU directives. The functioning of the system (effective from 1 July 2018) will be supervised by the Ministry of Internal Affairs, which will be issuing respective accreditations to providers of the services.

- Taxpayers who have filed their individual income tax return and immovable property tax return in other than electronic form although it was their duty to file electronically will be first asked to correct the situation and will be penalized only after they fail to do so. The financial administration also updated the list of filings to be viewed as filed correctly even if filed in other than electronic form while they should have been filed electronically.

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