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Editorial

Dear readers,

So the era of Donald Trump is now upon us. His victory is a further manifestation of the anti-globalization mood being felt in many parts of the world. The Brexit referendum was another. It seems unavoidable that this trend will lead to greater economic nationalism. Arguably this has already been seen in the slow progress of negotiations of trade deals such as the EU-US TTIP.

The effects will be felt also in the world of tax, especially transfer pricing, where governments are increasingly taking aggressive positions to maximize their tax revenues, an exception being Ireland. The international system for alleviating economic double taxation caused by transfer pricing adjustments is slow and ineffective, despite efforts of certain bodies to improve it. For some commentators, cases such as that involving Apple and other US technology giants are indicative of an ongoing EU/US economic conflict– also noteworthy is the $14 billion fine which the US Department of Justice is seeking to impose on Deutsche Bank for mis-selling of securities.

Despite the current negativity, there are still reasons to be optimistic about the longer term future. Cross border economic co-operation is such an ingrained everyday reality that it seems impossible for any person, not even a US President, to permanently reverse it. It is more likely that the current phase of economic populism is a kind of temporary experiment, to be abandoned once it becomes clear that it harms prosperity. In the meantime we hope that the Czech Republic can serve as a relative safe haven in a more turbulent world. Of course, the Czech Republic is not entirely immune from populist and nationalistic tendencies, and these can show themselves also in tax-related actions. But in a bigger picture, the country seems to be at ease with its status as a stable, open economy, welcoming trade and investment. Long may that continue!

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Taxes

Where to, income tax?

Discussions regarding a new long-awaited Income Tax Act have again been growing in intensity. In a recently published document the Ministry of Finance reveals some of its first intentions and concepts.

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The Ministry of Finance has recently published a document called *Summary of Innovative Solutions Regarding the Taxation of Income and the Payment of Related Statutory Insurance*, which is in principle a first theoretical and conceptual plan for the new Income Tax Act. The document does not include specific motions to amend the existing law but indicates (at least for now) some paths that could be followed in this tax area. The ministry's declared intention is to modernise, simplify and clarify the respective legal regulation and strengthen the tax neutrality principle.

The document shows that taxpayers may theoretically expect some simplifications and novelties. Worth mentioning are, for example:

- division of the income tax legal regulation into two separate acts;
- decrease in the number of depreciation categories to three plus the introduction of pool depreciation by type of asset;
- simplification of the definition of technical improvements: the ministry has put forward a revolutionary motion to stipulate the percentual threshold values of input cost to efficiently distinguish between repair and reconstruction, thus removing endless speculation in this respect. The threshold values would help decide what changes (i.e. potential repairs) can be regarded as technical improvement;
- a much-discussed exit tax: the ministry is not opposed to applying this tax in a scope larger than required by EU legislation;
- an attempt to remove conceptual inconsistencies of the current regulation, for example, an attempt to clearly define whether a certain tax regime can only be applied to a Czech concept or whether it can also be applied to its foreign equivalent.

However, the ministry's plan for now does not reflect any of the Common Consolidated Corporate Tax Base harmonisation approaches currently proposed by the European Commission for consultation before the European Parliament.

According to the ministry's current timetable, taxpayers ought to see the new income tax legislation in 2019. It is to become effective in 2020. In the same year, the ministry also intends to introduce the self-assessment principle (according to which taxes will be immediately and automatically assessed in the amount in which they were declared in income tax returns, for example, making the quicker refund of overpaid tax possible). The new Income Tax Act is still at a very early stage of its development and certainly faces a long way ahead before its final wording.

GFD's information on reverse-charge application on telecommunication services: some questions remain

The reverse-charge regime has been applied to selected electronic communication services since 1 October 2016. The General Financial Directorate (the "GFD") has published information that should have clarified reverse-charge application conditions. Nevertheless, some application aspects remain unclear.

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According to the government decree, from 1 October 2016 the reverse-charge mechanism should apply to the provision of electronic communication services:

(i) via access to electronic communication networks;

(ii) via interconnection of electronic communication networks; or

(iii) based on purchases or sales of these services;

in compliance with Act No. 127/2005 Coll., on Electronic Communication.

According to the GFD, the first two points relate to the provision of electronic communication services based on contracts for access to electronic communication networks or contracts for the interconnection of electronic communication networks under the conditions set by the Act on Electronic Communication. These should only apply to a limited scope of entities operating on a wholesale basis.

The last point raises the largest number of questions. According to the GFD, services involved should be those provided based on contractual relationships between two business entities operating in electronic communication (VAT payers) not regulated by a contract for networks interconnection or a contract of access under the Act on Electronic Communication, whereas the actual electronic communication services being re-sold do have the nature of supplies intended for access or interconnection.

Therefore, the majority of companies purchasing electronic communication services will have to determine whether they qualify as businesses operating in electronic communication and purchasing services for re-sale purposes or as end consumers. In the first case, purchases of these services would be subject to the reverse-charge mechanism; in the other case, a standard VAT regime shall apply.

The GFD specifically states that, for instance, where electronic communication services are purchased for re-sale within a holding of companies or for the re-sale of services rendered by companies engaged in procurement centralisation, the reverse-charge regime should apply. However, the GFD remains silent about the purchase of electronic communication services for re-sale to their own employees or their family members. As a result, tax advisors are currently attempting to clarify the approach to the application of reverse-charge in these situations directly with the GFD’s representatives.

We believe that the definition of a business entity operating in electronic communication services is crucial for the application of a correct VAT regime. Since the Act on Electronic Communication mainly defines general conditions for doing business in electronic communication, the Civil Code should help us define such a business entity. One of the basic features pertaining to business activities is the intention to generate profit. As a result, we are of the opinion that, in the case of the re-sale of telecommunication services to employees without a margin, employers that are business entities should not apply the reverse-charge mechanism on the purchase of these services.

Similar arguments can be used to deal with purchases of electronic communication services for the purpose of their subsequent re-sale without a margin within a holding of companies or to other group entities. In such cases, it is quite essential to consider carefully the setting of transactions between related parties, taking into account transfer pricing and the overall profitability of cooperation.

New calls under the ICT and Shared Services programme

At the end of October, first calls within the long-awaited second call under the Enterprise and Innovations for Competitiveness Operational Programme (OP EIC) were finally announced. In addition to calls designed for small and medium-size businesses, this also included calls for participation in the ICT and Shared Services programme for which large business may also apply.

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A separate call has been announced for each individual activity that is being supported. Below we summarise the most important information for large businesses.

Applications for support will be accepted via the MS2014+ electronic system from 16 November 2016 to 16 February 2017. All calls are single-round calls, which means that the quality of the submitted application is the most decisive factor. However, the governing body may interrupt the acceptance of applications when reaching the double of the required funds for allocation, but not earlier than 14 days after the application acceptance inception date.

Supported activities, the amount of aid, funds for allocation and eligible costs

creation of new IS/ICT solutions:

- minimum subsidy of CZK 1 million; maximum subsidy of CZK 50 million; total funds for allocation of CZK 2 billion;
- eligible costs: operating expenses in form of personnel expenses (50% of eligible costs in the minimum) and rent; investment costs in form of HW, SW and other costs associated with a project on a de minimis basis;

establishment and operation of shared services centres:

- minimum subsidy of CZK 1 million; maximum subsidy of CZK 100 million; total funds for allocation of CZK 0.7 billion;
- eligible costs: operating expenses in form of personnel expenses (50% of eligible costs in the minimum) and rent; investment expenditures in form of HW, SW and other costs associated with a project on a de minimis basis;

building and modernisation of data centres:

- minimum subsidy of CZK 10 million; maximum subsidy of CZK 120 million; total funds for allocation of CZK 0.75 billion;
- eligible costs: investment expenditures in form of costs incurred for the acquisition of buildings, land, building reconstructions, HW, SW and other machinery.

The maximum amount of aid for large businesses is 25% of all eligible costs in respect of all the supported activities.

Other selected conditions of individual calls

Projects must be carried out in the Czech Republic but outside of Prague. The number of projects per one applicant (one identification number) is limited to one active application; projects must be implemented within a period of three years of the date on which they are accepted. Recipients of aid for the *establishment and operation of shared services centres* must create at least 40 new jobs and assign them to employees that will perform technical activities in compliance with a centre's specialisation. In the case of recipients of aid for the *creation of new IS/ICT solutions* activities, four new jobs must be created and properly assigned.

2016 calls feature one **novelty**, which is the applicant's obligation to document their ownership structure up to the ultimate owner. In addition, all fixed assets must be acquired from third parties unrelated to the applicant. In respect of the *establishment and operation of shared services centres* and the *building and modernisation of data centres,* recipients whose projects have been approved for aid of CZK 50 million and higher must provide a sustainability guarantee in the amount of the funds allocated to the project before signing the decision on granting a subsidy. This guarantee must be in form of a pledge of real estate established in favour of the Czech Ministry of Industry and Trade, a creditworthy guarantor's warranty or a bank guarantee, while the guarantee must be effective over the entire project sustainability period.

Should you be interested in more details, please do not hesitate to contact us. We will also be happy to help you with the preparation of your project application.

Another amendment to the new Civil Code and Corporations Act

In late September, a group of deputies submitted to the government a bill partly modifying the yet unamended core regulations of the new private law – the Civil Code and the Act on Corporations. The proposed changes mostly concern unit owners' associations and housing cooperatives.

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The bill submitted by a group of deputies headed by Jeroným Tejc has a rather narrow focus, as it deals with essentially three topics. First, and without any further context, the deputies propose reintroducing to the new Civil Code the pre-emptive right to a co-ownership share in real property. Another topic involves unit owners' associations: to facilitate their functioning, several changes are being proposed. The process of approving changes to statements dividing real property into units is to be simplified. Furthermore, when transferring the ownership of units, it should be unambiguously stipulated that any transferor's debts connected with the administration of the building and land shall pass on to the transferee (the acquirer). And, to make credit financing more accessible for housing cooperatives, the deputies propose explicitly stipulating that the unit owners' associations may assume, accede to, or otherwise secure the cooperative' s debt arising from a loan taken for repairs or modernisation of the building.

The regulation of cooperatives in the Corporations Act is to be modified, namely as regards the convening of members' meetings: apart from publishing the invitation on a website, a meeting may also be convened by publishing the invitation on the cooperative's notice board. The decision-making on some changes to the articles of association should also be simplified.

The bill is now waiting for discussion by the Chamber of Deputies. However, it has not been okayed by the government. In its dissenting opinion, they mainly pointed out that the proposal only contains fractional changes and lacks a comprehensive approach to the issues. The ministers of the government pointed out that they would prefer a more comprehensive intervention in the legal regulation of unit owners' associations and housing cooperatives, referring to their own proposed amendment to the new Civil Code, which has now, nearly a year after its submission, passed through the third reading in the chamber and is waiting to be discussed by the senate.

For the sake of completeness, please note that an amendment to the Corporations Act is also waiting in the legislative pipeline: it concerns the obligatory participation of employees in supervisory boards of joint stock companies and is at the moment approaching its third reading. However, we are likely to see a larger legislative effort concerning the Corporations Act soon: the Ministry of Finance has completed an extensive amendment which is just being released for the commenting procedure.

With a lease of business premises you may be taking over the previous tenant's employees

The Supreme Court recently dealt with two similar cases – hospitality entrepreneurs started to operate in leased premises whose former tenants had carried out similar business activities. The new tenants were up for a most unpleasant surprise: according to the court ruling, with the lease of the premises they have taken over also the former tenants' employees.

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The court issued its ruling referring to a legal concept for which the Labour Code provides, titled 'transfer of rights and obligations under labour-law relationships'. The concept, in essence, means the obligation of an entity that continues in the business activity of its predecessor to also take over all its employees. The purpose of the regulation is that an employer's decision to discontinue their activity or to effect a structural change (such as a merger) would not necessarily lead to the redundancy of employees. The employees are taken over automatically – there is no need to terminate their existing employment or to negotiate a new contract. The original employment contract remains in force, as do the obligations from any collective bargaining agreements and other rights and obligations under the original employment relationships. Note that this was not the Czech legislators' idea: the regulation reflects the European Union's legislation.

In the cases recently before the Supreme Court, the new tenants tried to convince the court that their cases did not initiate a mandatory transfer. They argued that they only ever dealt with the owner of the premises and did not enter into any relationship with the previous tenants. Their lease did not even immediately succeed the previous tenants' lease and they did not take over any tangible equipment used by the previous tenants.

The Supreme Court, however, was not convinced. In line with the case law of the Court of Justice, it stated that a direct contractual relationship between the two employers is not necessary, and that a certain time delay between the termination of the existing tenant's activity and the initiation of the overtaking tenant's activity does not prevent the application of the transfer concept. The court, however, diverted from EU case law by denying the third argument presented by the new tenant: according to the CJEU, the transfer only takes effect if the new employer also takes over the tangible equipment necessary for carrying out the activity (unless the activity is based solely on human labour) from the original one. In this respect, the Czech Labour Code is stricter on employers than the relevant EU directive as it does not require the takeover of tangible equipment. This harshness of Czech law stands to be mitigated by an amendment to the Labour Code in 2017.

The duty to take over employees may arise not only when continuing a lease of premises, but also, for instance, when purchasing a production line or gaining a contract previously carried out by someone else for the same customer. Before entering into similar transactions, entrepreneurs should definitely consider a legal review that would bring the possible personnel implications to their attention.

G20/OECD revise their programmes to facilitate dispute resolution between tax administrations

In October, the OECD released key documents that form the basis of the Mutual Agreement Procedure (MAP) peer review and monitoring process under Action 14 of the BEPS Action Plan.


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Action 14 aims to make the mechanism of resolving disputes between states arising from double taxation treaties more effective. Currently, such disputes may take years. The newly released documents regulate the assessment methodology for the peer review and monitoring process, and the MAP statistics reporting framework. Through peer review, the OECD seeks to point out the (in)effectiveness of dispute resolution in individual states. Within statistics reporting, individual states have to state how many MAP disputes they are solving, how many were closed during the year and how long it took to settle individual cases. This should provide for a higher transparency of MAP processes and motivate individual states to resolve disputes at a greater speed.

The results of the peer review and analyses will be released gradually; the first part is to be published in December 2016, to be followed by comments by taxable entities.

Ireland to appeal against the EC's Apple ruling

In September, the European Commission ruled that Ireland had granted an undue tax advantage of EUR 13 billion to Apple, which it now has to recover from the company. In early October, the Irish finance minister prepared an appeal against the EC's decision.

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The appeal is based on the following key arguments:

- The preferential tax regimes that Ireland was supposed to have granted to Apple do not exist.
- The damage arising from the case may threaten the credibility of Ireland in the international tax debate.
- The European Commission in its ruling has undermined the existing principle of international taxation that states that profits should be taxed where generated.
- The companies involved are not Irish tax residents.
- The US Department of the Treasury has expressed concern that the ruling will lead to Apple paying less tax in the US.
- The European Commission's allowing other jurisdictions to tax the amounts that Ireland is required to recover from Apple is highly controversial.
- By its ruling, the European Commission intrudes upon the sovereignty of member states in tax matters, causing uncertainty for businesses as such.
- Ireland does not have any legal title to recover the EUR 13 billion that, according to the European Commission, Apple should have paid in tax.

Incorrect APR in contracts: a costly error

The Supreme Court recently ruled on the issue of an incorrectly calculated annual percentage rate of expense (APR) in a consumer credit contract: if the APR is stated in the contract in an incorrect amount, this constitutes a breach of the information duty. This may result in the credit providers having to apply a significantly lower interest rate, or, possibly having to return the already paid interest to the customer.


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The Consumer Credit Act gives a list of obligatory information that a consumer credit contract has to contain for the sake of consumer protection. The APR has to be included in this essential information. A case dealing with an incorrect amount of APR in a contract was addressed by the Supreme Court in its recent ruling. The credit provider demanded the client repay the principal amount of a credit and contracted interest. The customer (defendant) in turn claimed that the credit provider did not have the right to collect the interest as the amount of APR had been misstated in the consumer credit contract.

In its ruling, the Supreme Court concluded that the only way a credit provider can comply with its duty to state the necessary information in the contract is by providing all the required data in a complete and accurate manner. Should the credit provider miscalculate the APR or intentionally misstate its amount, statutory duties have not been met. Such error on the part of the credit provider is penalised by law by imposing a CNB discount rate of interest on the credit (instead of the contracted rate of interest), and by rendering invalid any arrangements regarding other payments for the consumer credit (such as a fee for opening the credit). In the case before the Supreme Court, this would mean that, instead of a contracted interest rate of 25% p.a., the consumer credit would bear a CNB discount rate, which has been about 0.05% p.a. for years. The credit provider would thus have to return to the customer all interest already paid in excess of the 0.05% rate, plus all other payments made by the client apart from the instalments on the principal amount.

The decision may have very unfavourable implications for credit providers: if they fail to state the obligatory data in the consumer credit contract or state them incorrectly, they will have to deal with the clients requesting refunds of contractual interest paid in excess of the CNB discount rate, and of other payments for the provision of the credit.

SAC: toll manufacturing should not result in loss

The Supreme Administrative Court recently dealt with yet another transfer-pricing case. The dispute involved the entitlement of a toll manufacturer to report losses due to unfavourable developments in the target market.

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The controlled entity manufactured cables using raw materials provided by the parent company and, according to the transfer-pricing documentation, operated as its detached manufacturing plant. The transfer price was set as the price per minute of manufacturing service and the transfer price was updated every six months. In 2008, the manufacturer incurred a loss due to a significant drop in the production volume.

The tax administrator levied additional tax onto the entity as a percentage of actually incurred costs, using the tax administration's own Amadeus-based comparative analysis. The administrator did not acknowledge the drop in output as an argument, claiming that the manufacturer did not control the utilisation of its production capacity. Moreover, the documentation explicitly stated that the "detached manufacturing plants do not bear any other risks but those linked to their production function".

The Supreme Administrative Court confirmed the legitimacy of the profit adjustment by the tax administrator (5 Afs 194/2015). According to underlying documentation submitted by the manufacturer during the tax inspection, the cost plus method should have been applied, taking into account all production costs. According to the court, it was appropriate to remunerate the total production activity.

What is positive about the tax administrator's approach is that it compares the Czech manufacturer's profitability against the lowest values of profitability for entities selected within a comparative analysis. Negative is that the tax administrators did not deal in much detail with the activities that were in fact carried out by the companies being benchmarked and relied solely on the provided code of classification of economic activities.

The decision is a confirmation of the tax administrator's consistent long-term approach towards companies whose functions are significantly restricted, particularly when such a fact also emerges from the presented transfer-pricing documentation.

We expect that the decision will back tax administrators and that loss-making companies operating as contract manufacturers or toll manufacturers will continue being easy prey for the tax administrator in the future. Timely and diligent preparation for a transfer pricing inspection as well as consistent argumentation to support any losses is therefore highly recommendable.

Case law

Tax authority's duty to produce evidence

The Supreme Administrative Court's recent judgment concerning the entitlement to VAT deduction reminds us that not only the taxpayer must prove facts during tax proceedings but also the tax authority. The tax administration's attempt to shift the duty to prove facts in evidence proceedings entirely onto taxpayers does not stand before the courts.

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The SAC judges have again dealt with the issue of spreading the burden of proof between the VAT payer and the tax authority. Recent Judgment No. 6 Afs 170/2016 observes that both parties involved in tax proceedings, i.e. the taxpayer and the tax authority, have the duty to produce evidence. In this particular case, the tax administration challenged the entitlement to VAT deduction, claiming that the VAT payer did not properly document a supply performed by the supplier stated in a tax document. During appellate proceedings, the Financial Directorate then confirmed the tax authority's decision to cancel the entitlement, this time by asserting that the VAT payer knew, or might have known that they had received a supply affected by VAT fraud.

The SAC held that the above two reasons for cancelling the entitlement cannot be freely combined. If the VAT payer fails to prove the receipt of a supply from a specific supplier, it is not appropriate to examine potential VAT fraud involvement or to apply the "should-have-known" test. With respect to VAT fraud, the SAC objected to any further expansion of the VAT payers' duty to produce evidence. The court pointed out that any potential involvement in VAT fraud would not be a matter put forward by the taxpayer themselves. It is therefore solely the tax administration's duty to collect sufficient evidence to prove the VAT payer's involvement in VAT fraud. This duty may not be foisted off on taxpayers, according to the court.

Considering the above, during tax inspections we recommend approaching any requirements and assertions made by the tax authority with healthy scepticism. Our practical experience has shown that not all tax authority requirements are legitimate. The outcomes of tax inspections are always worth analysing critically, taking into account the justifiability of the tax authority's conclusions and their substantiation with sufficient evidence.

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