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Editorial

Let's start with the good news. According to fresh statistical data, the Czech Republic's economic health is slowly improving. And the recovery of the Czech economy has come even earlier than economists expected: Fitch credit rating agency has already changed the Czech Republic's outlook from negative to stable.

However, companies and entrepreneurs must constantly be on the alert, as after the drastic changes brought by the consolidation package its amendment is already being prepared. Deputies have decided to fix the faulty provisions. One of the problematic areas is the regulation of concurrences of agreements to perform work (outside employment) translating into considerable complications in practice. The changes expected to take effect from July have thus been abolished, and the situation is to be resolved by means of an amendment to the Investment Companies Act with the introduction of a preferential regime of ‘notified agreements’. The parameters of the preferential regime and its application are summarised in the Tax and Legal Update’s section on taxes.

If nothing else, there is at least more clarity in the taxation of events organised by an employer for employees: popular Christmas parties and company events will still fall under the scope of events tax-exempt on the employee's part. This will please many, perhaps more than the positive results of the national economy. And it is understandable - employee wellbeing is not to be underestimated.

Here’s hoping for a pleasant spring for employees and employers alike!

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Taxes

Technical amendment to consolidation package on horizon

As part of the second reading of an amendment to the Act on Investment Companies (Print 570), the coalition deputies have submitted proposals to amend the Income Tax Act and other laws amended at the end of 2023 within the consolidation package, aiming to clarify some of the inaccuracies contained in these amendments.

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Personal income tax: non-financial benefits

Events organised by employers

The proposal specifies the scope of tax-exempt cultural and sports events organised by employers for employees and their family members and redefines them as employer-organised social events, including those having cultural or sporting elements. This confirms the interpretation that these events may include Christmas parties, company anniversary parties, St Nicholas Day parties, etc. The proposal highlights that the employees' income from these events should be in non-financial form. The condition that the events must be ordinary and reasonable in scope and form, for a limited number of participants, and that related expenses are not tax deductible for the employer continues to apply.

Determining the amount of non-financial income related to childcare facilities

The draft amendment provides for a special method to determine the amount of non-financial income of an employee using childcare facilities (including kindergartens). The employee's income will be either the price commonly charged at the place and time for a pre-school facility established by a public entity (e.g., a state, region or municipality) or the highest monthly payment for pre-school education according to the Decree on Pre-School Education, i.e., a maximum of **8% of the minimum monthly wage** applicable in a given month (**CZK 1,512** for 2024). The measurement method shall be chosen by the employer for each employee's child separately. It is also necessary to consider the period during which the child uses the pre-school facility in a given month. The employee's non-financial income will then be the difference between the amount determined as described above and any payment made by the employee to the employer. The proposed regulation should apply **retroactively from 1 January 2024**.

Meals for former employees

The amendment proposes to expand the range of employees for whom the employer will be able to exempt from tax the non-financial benefits in the form of meals for direct consumption at the workplace or for direct consumption at a catering facility operated by another entity. This will also apply to employees having worked for the employer immediately before retiring on an old-age pension or a third-degree invalidity pension. In aggregate, **up to 70% of the upper limit of the meal allowance** provided to employees receiving salaries on a domestic business trip of 5-12 hours (i.e., **CZK 116.20** for 2024) may be exempt from income tax. Thus, these former employees will not be required to have worked at least three hours per shift/calendar day to qualify for the exemption. The exemption will be applicable to income provided as early as 1 January 2024. This change does not affect monetary meal allowances or multi-purpose meal vouchers, which will continue to be subject to the legislation currently in force.

Less strict condition for exempting income if used for one's own housing needs

It has been proposed to change the notification condition for the exemption of income from the sale of real estate in which the taxpayer has resided for less than two years or has owned for less than 10 years if the taxpayer uses the funds to provide for their own housing needs. Such an exemption will no longer be conditional on submitting the notification. The taxpayer will still be obliged to submit the notification to the tax administrator by the end of the deadline for filing the tax return, however, failure to comply with the notification obligation will not lead to loosing the entitlement to exemption, as is the case now. It will be penalised despite its non-financial nature, but the tax exemption will remain in existence. According to the transitional provision and the explanatory memorandum, the amendment should already apply retroactively for the 2023 taxable period.

Statutory insurance premium payments for employee stock option plans

The plan to synchronise insurance regulations with the already valid tax regulations concerning the acquisition of shares in a business corporation or (transferable) options to acquire such shares by an employee under employee stock option plans is underway. The point in time when income is subject to insurance premiums will be linked to the point in time when the income is taxed (more on the tax-related changes in the January 2024 and November 2023 issues of the Tax and Legal Update). At the same time, if the employer reduces this income due to a decrease in the market value of the share under the Income Tax Act, the reduced income will be subject to the relevant insurance premiums.

Income tax and statutory insurance payments for concurring agreements to perform work (outside employment)

The problematic changes resulting from the consolidation package concerning agreements to perform work outside employment, due to come into force on 1 July 2024, will be further amended. It is proposed that a special 'notified agreement' scheme be introduced. For employees under the notified agreement scheme, the obligation to participate in sickness and health insurance will only arise in the relevant month when the threshold of **25% of the average wage** (**CZK 10,500** per month in 2024) is reached. If the income from all agreements to perform work of an employee for an employer who has used the notified agreement scheme does not reach this threshold, the obligation to participate in the insurance scheme shall not arise. At the same time, this special scheme will also be applicable for the purposes of income tax on employment: the taxpayer will be able to apply withholding tax on such income if the amount of such income from the agreement or from all agreements with a registered employer does not reach **CZK 10,500** per month.

Income from agreements to perform work generated with other employers, i.e., those not under the notified agreement scheme, will be subject to sickness insurance payments if remuneration of at least **CZK 4,000 per month** has been agreed on or if the relevant income in a given month is at least CZK 4,000.

Only the employer who first notifies the Czech Social Security Administration (CSSA) in a manner similar to that for claiming the tax credit by part-timers will be able to apply the preferential notified agreement scheme to the employee in a calendar month. If the employer applies the notified agreement scheme, they will have no further obligation towards health insurance companies, as these will obtain the information directly from the CSSA.

The payment of insurance premiums on agreements to perform work under the above scheme should not become effective earlier than 1 January 2025. The current wording of the law, which is valid but not yet effective, will be repealed. Until the end of 2024, the existing approach to taxation and insurance payments should be applied to agreements to perform work. The registration obligation will already apply from 1 July 2024.

Corporate income tax

Exclusion of unrealised FX differences from income tax base and transition to functional currency

The consolidation package introduced the possibility for taxpayers to apply the regime of exclusion of unrealised FX differences for corporate income tax purposes. The amendment extends the range of cases where this regime automatically ceases, by operation of law, to situations involving a transition to a functional currency in accordance with the Accounting Act. When switching to a different accounting currency, taxpayers shall follow the same procedure as in other situations (e.g., entering into liquidation) and adjust their result of operations for any previously excluded unrealised FX differences arising from the original accounting currency.

Functional currency and foreign currency translation for the purpose of income tax return preparation

Taxpayers who use their functional currency in their accounting must still file their income tax returns in Czech crowns. The amendment specifies the FX rates to be used in the conversion of fixed assets, debt, provisions created for income tax purposes, and other items measured in the accounting currency. For items that are kept in the accounting records (e.g., the input costs of assets for tax depreciation purposes), taxpayers shall use the general FX rate applied in the accounting records. The general FX rate announced for the last day of the taxable period will now be only used as a secondary method of conversion where there is no link to accounting and therefore no FX rate for accounting purposes.

Non-deductible expenses related to employee benefits

The employer's expenses for social events, including those with cultural or sporting elements, are to be added to the list of expenses non-deductible on the employer’s part so that the wording matches the one for the purposes of exemption of such expenses on the employee's part. As regards the calculation of non-deductible expenses in facilities designed to meet the needs of employees (expenses exceeding the income from these facilities are considered deductible for income tax purposes), the amendment clarifies that for the purposes of this calculation, expenses that are non-deductible under other provisions of the Income Tax Act shall not be included.

Most provisions on corporate income tax are proposed to take effect on **1 July 2024**, or their effective date has been linked to their publication in the Collection of Laws.

Taxes

Details of 2025 amendment to VAT Act - Part I

The draft amendment to the Value Added Tax Act, currently in the external comment procedure, introduces extensive changes as it transposes EU directives and responds to CJEU rulings and practical experience. Below we present the first part of these significant changes.

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Supplies provided to employees

Where an employer provides supplies to their employees (or close persons) for a symbolic price, the relevant tax base will now be determined based on the supplies' open market value. Employees will continue to be able to accept the supply at any price or at a significant discount, but employers will have a new obligation to pay output tax based on the open market value of such a supply. The new regulation derives from the VAT Directive that allows employees and their relatives to be in legal ties with the employer. This change is likely to lead to higher VAT payments.

Changes to deadlines for claiming the right to deduct VAT or correcting the VAT base

The amendment introduces changes to the time limits for claiming a VAT deduction or correcting the tax base. The **deadline for claiming a VAT deduction** is to be shortened from 3 to 2 years. If the taxpayer wants to exercise their right to deduct VAT based on a debit note, the deadline shall further be shortened to just 12 months. The only exception to this rule is for received supplies where the obligation to pay the tax falls on the supply recipient. Here, the deadline is already provided in the existing VAT Act.

The amendment also significantly extends the time **limit for corrections of the tax base** to 7 years from the original supply. The related time limit - the limit for adjusting the deduction – remains the same and is based on the limit for correcting the tax base.

Unpaid liabilities and obligation to refund the VAT deduction

In response to the CJEU's case law, the amendment provides that debtors will be obliged to make corrections and reduce the VAT deduction if receivables are not paid within 6 months after their due date, either in part or in full (depending on the actual payment). Where a receivable arising from a taxable supply is subsequently satisfied in full or in part, the taxpayer is entitled to increase their right to deduct again. This implies that taxpayers will be

obliged to monitor the due dates of their liabilities for VAT purposes as well.

Other selected changes

We also recommend paying attention to other proposed changes, such as:

- introduction of a small business regime
- changes to compulsory registration
- abolition of internally produced asset concept
- changes to corrections of the tax base relating to irrecoverable receivables
- certain changes to the supply of immovable property.

As this is still only a draft amendment, it is highly likely that changes will be made during the legislative process. We will discuss the most important ones in the next issue of *Tax and Legal Update*.

Amendment to VAT Act to narrow scope of exempt financial activities

The Ministry of Finance is proposing to significantly narrow the scope of financial activities exempt from VAT in a forthcoming amendment to the VAT Act. The aim is to align the Czech VAT Act with the EU Directive and the interpretations of the Court of Justice of the European Union.

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Under the amendment, the following activities would no longer be included in the list of exempt financial activities for which financial institutions are also not entitled to deduct VAT:

- organisation of a regulated market in investment instruments
- management of a customer's assets based on a contract with the customer where the assets include an investment instrument, except for the administration and custody of investment instruments
- keeping records of investment instruments
- settlement of trades in investment instruments
- procurement of collections
- collection of radio and television licence fees
- payment of pension benefits or recovery of recurrent payments from the public.

For the first four of the above services, according to the explanatory memorandum, the proposed amendment reflects the fact that these do not involve transactions in securities but administrative and custodial activities. Under the VAT Directive and the CJEU's case law (e.g., judgment in Case C-44/11 Deutsche Bank), these types of services cannot be exempt from VAT.

For the last three types of services, the reason for the abolition of the exemption is that these involve debt recovery and not payment services from a VAT perspective. Debt recovery cannot be exempt from VAT under the VAT Directive and the CJEU's case law (e.g. C-175/09 AXA UK). 'Debt recovery' is not defined in the directive and, according to case law, can also refer to debts that are not yet due.

Financial service providers should analyse the impact of the proposed changes, review the VAT treatment of outputs, and assess the impact on the right to deduct input VAT. They should also pay attention to reconfiguring their IT systems. If the service is to be subject to VAT, tax invoices will need to be issued.

Also the customers of these services need to consider the impact of the proposed changes. For example, if a domestic customer (a VAT payer or person identified for VAT) receives one of the above listed services from abroad, they will now be obliged to declare VAT on that service in the Czech Republic and should also assess whether or to what extent they will be entitled to deduct relevant VAT. It can be expected that a recipient financial institution's right to deduct will be rather limited.

This new regulation raises several questions, and the possible implications are currently being discussed among the professional community. The current draft amendment sets the effective date at **1 January 2025**. Considering its significant interference with the existing functioning, it is to be expected that proposals to postpone its entry into force will be made, to allow the financial institutions more time to prepare for the changes.

ViDA - digital reporting and e-invoicing still music of the future

The proposal for a VAT in the Digital Age (ViDA) Directive that would modernise and advance the EU's single VAT system is running behind schedule. The proposal did not move forward during the Spanish Presidency of the Council of the EU, but in the programme statement of Belgium, holding the Presidency of the Council of the Union in the first half of this year, digitisation and in particular the ViDA proposal are high on the agenda.

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The Belgian presidency will address VAT as one of the key points of its tax and customs agenda. The priority of the ViDA proposal and of the Belgian presidency is to eliminate the VAT gap (the difference between expected and actually collected VAT). The proposal is essential to maintain the fairness and efficiency of the tax system at a time when the digital economy is becoming increasingly important. The Belgian presidency puts emphasis on the modernisation of tax rules to better match current trends and the needs of the EU.

The original proposal for the ViDA Directive envisaged the introduction of Pillar 1, i.e., the possibility for member states to introduce compulsory e-invoicing at the intra-community level as early as in 2024. In addition, new rules for digital platforms (Pillar 2) were planned with effect from 2025 and a single registration for VAT purposes (Pillar 3) with effect from 2028. However, the current delay of the ViDA proposal postpones the potential validity of each agenda to sometime in the future. It is estimated that all digital reporting under Pillar 1 will be delayed until 2030, with the other two pillars having to wait for at least one year.

These delays will most likely have a significant impact on the harmonisation and efficiency of the tax system. It is therefore important for the Belgian presidency to address this issue, give it the appropriate attention, address the pressing issues raised by the member states regarding financial reporting, and urge an EU-wide solution to this situation.

Ministry of Labour and Social Affairs plans further changes to employment of foreigners

The Ministry of Labour and Social Affairs is planning stricter penalties for illegal work and disguised employment mediation. The absence of a prior (final and conclusive) penalty for these offences will now be a precondition for employing foreigners in the Czech Republic. A recognised employer register is to be established so that companies can prove their clean record. The draft amendment to the Employment Act also includes extending the register of offences and making it accessible to the public.

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The key novelty to be brought by the bill is the ‘recognised employer’ concept. Only entities included in the register of recognised employers will then be authorised to employ foreigners in the Czech Republic. Registration will not be automatic, and it will be necessary to apply for it.

The bill also contains several conditions that an employer wanting to be registered must meet as at the date of the application. First, the employer must have been doing business in the Czech Republic for at least 24 months, be a tax resident here, and have had at least one employee participating in the social insurance system for six consecutive months. If the applicant is registered in the commercial register, all financial statements must have been properly filed.

The applicant must also not have a record of arrears exceeding **CZK 10,000** with the customs or financial administrations or with social security and health insurance institutions.

Two years without a fine

Another condition for the inclusion in the register will be the absence of fines for offences of illegal work and disguised employment mediation in the 24 months preceding the application. The above also applies to other breaches of labour law obligations for which the company was repeatedly fined more than **CZK 50,000**.

Employers will be required to comply with these requirements throughout their registration, with compliance being verified once per calendar quarter. The ministry hopes that this will reduce illegal work, labour exploitation, and disguised employment agency activities, which are still widespread.
Under the bill, offenders in the area of illegal work and disguised employment mediation should be registered in a public register of offences. The ministry relies on the preventive effect of this measure, as contractors often refuse to cooperate with offending entities. Apart from the basic identification of the offender, the amount and date of the penalty, the offender's residence, and the type of offence should also be included in the register of

offences.

Points system

Finally, a points system is to be introduced. Under the bill, a foreigner must achieve a certain score according to preferential criteria to obtain a work permit, an employment card, and a blue card. Preferential criteria include employment characteristics, language skills, education, age, and work in strategic sectors. The scoring system is to be determined by a government decree.

The amendment to the Employment Act will bring many new obligations for employers who employ people from abroad. Except for the points system, all the changes are to **take effect from 2026**.

Redefining relevant market in competition law

For the first time since 1997, the European Commission has adopted a new notice on the definition of the relevant market. The definition plays a crucial role in the assessment of cartels and mergers, and in other areas of competition law. The notice responds to developments in the Commission's decision-making practice, the CJEU's case law, and on the market, in particular the rise of digitisation and globalisation.

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The relevant market

The definition of the relevant market, consisting of the relevant product and geographical market, is a valuable tool in competition law. It allows undertakings and competition authorities to determine the boundaries between actual and potential competitors, calculate their market shares, and thus assess their market power. Ultimately, it is a key tool to assess whether, e.g., an undertaking can benefit from certain exemptions from the prohibition of cartels or simplified merger clearance procedures, and whether it has a dominant position.

The Commission has left the basic concept of the relevant market unchanged: the relevant market is still defined by products that are interchangeable and substitutable, and by a territory with homogeneous competition conditions. The relevant market can thus be limited to a small municipality or a single country or extend to the EU or even the whole world. For example, the Commission notes that if customers have access to the same suppliers all over the world under similar terms regardless of where the customer is located, the relevant geographic market is likely to be worldwide.

Alternative indicators for calculating market share

However, the way in which the relevant market is defined is changing. While in the past, price used to be a key parameter, now the Commission recognises the importance of non-price parameters, especially where the service is available free of charge (e.g., for multi-sided platforms). It also lists additional indicators for determining market shares, such as the number of suppliers, capacity, number of active users, number of website visits, number of downloads, volume or value of transactions concluded over the platform, etc. To promote their products, multi-sided platforms often offer some products free of charge (e.g., basic membership or app versions). In such cases, traditional tools such as the SSNIP test cannot be effectively used. The SSNIP (a small but significant and non-transitory increase in price) test defines the product market by looking for a substitute for the reference product in the event of a slight increase in price. Therefore, the Commission places more emphasis on non-price parameters such as the degree of innovation, sustainability, durability, the possibility to integrate the product with other products, privacy, etc. if customers take them into account in their purchasing decisions.

SSNIP test clarification

In view of digitisation and globalisation, the notice focuses in more detail on digital platforms (e.g., payment card systems, social networks, etc.) or highly innovative industries. Equally importantly, it clarifies certain procedures applied in defining the relevant market, such as the SSNIP test, which should make the definition of the relevant market easier in practice.

After-markets, bundles and (digital) ecosystems

The notice also outlines a way to define the relevant market in cases where the consumption of a durable product leads to the purchase of another related product (after-markets) or where customers consume several products together as a bundle (e.g., a package holiday with a tour operator). In the case of (digital) ecosystems consisting of a primary core product and several secondary (digital) products connected by technological links or interoperability (e.g., products linked by operating system, services, and applications), similar principles as in the case of after-markets and/or bundled services can be applied to define the relevant product market(s).

The Commission expects the revised notice to enhance transparency and legal certainty for all market players and to allow for a more effective enforcement of competition rules. In turn, the notice may help businesses avoid potential breaches of competition law.

Regulated gender ratio in companies

The Czech Republic must comply with obligations under EU law regarding the gender balance in the management of certain listed companies. The Minister for European Affairs proposes to stipulate the new obligations in an amendment to the Capital Market Undertakings Act

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Who will be affected by the new obligations?

The new obligations will apply to joint-stock companies whose shares are publicly traded on a regulated market in the EU. Another condition is that the issuer must have at least 250 employees and at the same time an **annual net turnover of EUR 50 million** or **assets of more than EUR 43 million**. The new obligations will thus not affect medium-sized, small or micro-enterprises, even if their shares are traded on an EU regulated market.

Key obligations of issuers

Issuers will be required to set a target gender balance for members of its governing body (board of directors, management board or supervisory board) assuring that at least 40% of its non-executive board members or at least 33% of all board members are women. The issuers will also have to publish on their websites (e.g., as part of their annual report) information regarding the achievement of these targets. The Czech National Bank will also publish a list of issuers meeting the targets.

The issuer shall first assess the suitability of a candidate for the position of a board member from the viewpoint of the set gender balance targets. In making this pre-selection, the issuer must give preference to a candidate of the less represented gender if they have the same or comparable qualifications (qualification, competences and expected performance). Exceptionally, the issuer may select another candidate, possibly to meet other diversity policy objectives or for reasons of special consideration. At the request of a candidate who was not pre-selected, the issuer shall provide information on the qualification criteria for the selection, an objective comparative assessment of the candidates, and the reasons that led to the selection of the candidate belonging to the under-represented gender. Candidates who pass this pre-selection process will then as a rule be voted on by the general meeting.

The issuer will also have the duty to inform their shareholders (or employees) of the set targets and the penalties it faces for breaching the rules.

Sanctions

Failure to meet the set targets will not in itself be an offence, but the following will be:

- The annual report does not contain the required information.
- The issuer has not set any gender balance targets.
- The issuer has breached the rules for the pre-selection of a candidate for a member of the governing body.

- Despite their request, an unsuccessful candidate was not provided by the issuer with information on the reasons for their exclusion from the selection.

The issuer can be fined up to **CZK 1 million** for the above offences.

Effective date of the act

There is still time to prepare for the new responsibilities, as the law is now going through the comment procedure and will have to advance through the legislative process. The amendment expects to take effect on **28 December 2024**, which is the date on which the transposition deadline set by the European Directive expires.

Tips and tricks

Can penalties be waived where abuse of tax law has been involved?

Cases of abuse of law are nothing new in the tax area. Is it possible to successfully apply for waiver of at least part of the penalty resulting from the assessment of additional tax under these circumstances? Can the tax authority deny the waiver on the grounds that there has been an abuse of law?

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The Supreme Administrative Court (SAC) addressed this issue in one of its recent judgments. The tax authority dealt with an issuance of one-crown bonds, concluding that the presented scheme was an abuse of law. It therefore assessed additional tax including penalties, against which the company unsuccessfully defended itself in appeal proceedings and subsequently in court. We wrote about the case here.

At the same time, the company applied for the waiver of the related penalty. The tax authority denied the request claiming that the conduct involving an abuse of law was so serious that the penalty could not be waived. The company fought the rejection of its request before the courts.

According to the courts, an abuse of law in itself does not enjoy legal protection, and such legal protection cannot be granted even to the related penalty. Although the company defended itself by arguing that it had paid the tax in the early stages of the tax proceedings, this did not convince the court. The court held that in this particular case, the taxpayer's conduct could not enjoy the state's generosity (exceptional favour) in the form of a waiver of the penalty, as this would lead to promoting the abusive conduct.

The court also disagreed with the company's argument that the General Financial Directorate's instruction on the waiver of penalties did not expressly provide for the possibility of denying a waiver on the grounds of an abuse of law. According to the court, it is important that the instruction does not exclude it. The possibility of considering the taxpayer's original conduct when waiving penalties has already been established by the SAC's case law in the past. Thus, in abuse of law cases, it cannot be relied upon that part of the penalty will be waived even if all other conditions are met.

New OECD report on Pillar One – Amount B

The OECD's Pillar I and Pillar II initiatives to reform international taxation aim to address tax challenges arising from the digitisation of the economy and ensure a fairer distribution of profits and taxing rights among countries in the globalised world. A recent outcome of these initiatives has been the introduction of a 15% global top-up tax (Pillar II). The Pillar One Amount B report now released has the ambition to simplify the setting of arm's length returns on sales for wholesale distributors.

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Targeting mainly the world's largest corporate groups, Pillar I sets rules for the redistribution of part of their profits to the countries where their products are sold (market jurisdictions). Among the issues discussed is the allocation of a return on sales percentage (Amount B) in the market jurisdiction; this is covered in the new report on *Pillar I - Amount B* dated 19 February.

Amount B will become part of Chapter IV of the OECD Transfer Pricing Guidelines, the interpretative framework for arm's length pricing in the Czech Republic. Unlike Pillar II, the new rules for Amount B are not limited by the size of the corporate group or company. Potentially, the rules could be implemented **from 1 January 2025**.

The report proposes that jurisdictions implement a simple return on sales matrix that under certain conditions should be applied to wholesale distributors or sales agents who would thus have the certainty of a correct profit indicator in the jurisdiction that has adopted the guidelines, without extensive benchmarking. **Among other conditions, to be able to apply the matrix**:

- the taxpayer must be a wholesale distributor, sales agent or commissionaire involved in the sale of goods
- the taxpayer must not trade in commodities or intangible assets
- non-distribution activities must be separable from distribution activities
- retail revenues must not exceed 20% of three-year average revenues
- in the transaction under review, annual operating expenses must not account for less than 3% or more than 20% (30%) of revenues.

Jurisdictions that choose to implement Amount B can choose between two regimes: under the first regime, the simplified and streamlined approach using Amount B is voluntary, and companies may still demonstrate that their transactions are at arm's length using their own benchmarking (essentially a safe harbour regime); the second regime allows the jurisdiction to recommend or demand the use of the return on sales as per the report by all companies that meet the criteria.
While the intention is certainly commendable, the report itself raises several implementation issues. First, it is not clear which countries will adopt the rules resulting from the report and when. New Zealand, for instance, has

already announced that it will not adopt the rules because of its sufficiently developed tax system, while India also has significant reservations against the report. This suggests that if some jurisdictions adopt the new rules while others do not, it may lead to increased administrative costs and paradoxically result in double taxation.

Moreover, the use of a simplified profit indicator matrix requires a clear identification of the transaction and the demonstration that quite robustly defined criteria have been met, which goes against the intention to simplify the documentation agenda. Finally, the methodology used in the development of the Amount B profit indicator matrix does not correspond, e.g., to the methodology for conducting comparative analyses recommended for the Czech Republic by the General Financial Directorate's Instruction D-34, which may lead to significantly different results and the reluctance of the Czech tax administration to accept the rules set in the OECD report on Amount B. It is not yet clear which approach the Czech Republic will take.

The report on Amount B is thus aimed rather at developing countries, while questions remain as to its implementation in developed tax systems (including ours). However, it is advisable to monitor Pillar I and the implementation of Amount B, and possibly to model the impact of these rules, particularly for taxpayers with distribution activities in developing countries.

KPMG's detailed analysis is available here.

Subsidies

Some OP TAC calls postponed

The Ministry of Industry and Trade has updated the schedule of calls to participate in the Operational Programme Technology and Applications for Competitiveness for 2024, postponing several calls also designed for large enterprises.

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The ministry plans to announce the call to participate in the **Energy Savings programme** in the second quarter of this year (instead of March). This call is intended to support the use of renewable energy sources, the use of waste energy, the reduction of energy consumption in buildings, the modernisation of production processes, etc. The ministry has also postponed the announcement of the call to obtain **support for wind power plants** to the second quarter of 2024.

The call under the **Applications programm**e is scheduled to be announced in the third quarter of this year. This call is intended to support industrial research and experimental development. Large enterprises may participate only if the project is carried out in effective cooperation with an SME. The ministry has also reduced the funds available for allocation from CZK 3 billion to CZK 1.5 billion.

In addition to the above calls, we can expect more calls to be announced during 2024 in popular programmes such as **Potential** (Q2), **Infrastructure Services** (Q3), and **Sustainable Water Management** (Q4).

The last call in the **Potential programme** was intended for SMEs, small mid-caps, and mid-caps, i.e., enterprises with up to 3,000 employees. The range of eligible applicants will be specified in the call once it has been announced.

Case law

New case law on proving direct link between expense and income

Recent case law has again confirmed how difficult it can be to apply a special provision of the Income Tax Act allowing non-deductible expenses to be considered deductible up to the amount of the related income or income to be considered non-taxable if it is related to non-deductible expenses. At the same time, the court decisions below also show that an economic link between income and expense is not sufficient, as there must be a direct link, i.e., a sufficiently intense and unmediated logical link between income and expense.

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The Municipal Court in Prague ruled on a case (3 Af 4/2020 48) where a company operating in pharmaceutical distribution treated expenses typically considered as non-deductible (such as entertainment costs, non-deductible gifts) as deductible for income tax purposes on the grounds that these expenses were directly included in the calculation of its income. The company's pricing model consisted of the sum of its direct and indirect operating expenses plus a margin of 5%. The company therefore assumed that the conditions for the application of Section 24(2)(zc) of the Income Tax Act had undoubtedly been met, including the direct link between expense and income.

However, the court argued that the **direct link between expense and income could not be inferred merely from its direct inclusion in the price calculation**. The key is to show that had it not been for the expenses in question, the customer would not have purchased the goods or would not have done so on the given terms. The fact that the price was determined using the "Cost+" method based on non-deductible expenses does not make these expenses directly related to the generated income. According to the court, the direct link between expense and income must be understood to mean that the expenses in question could have influenced the amount of income, not only by being incurred and subsequently charged to other entities, but also in such a way that their incurring contributed to the generation of income in a way other than by automatically increasing it. It is thus necessary to prove a direct link to the services provided to customers and to distinguish whether the expenses actually benefit the customer or instead only the company itself. The Municipal Court's conclusions are yet to be examined by the Supreme Administrative Court.

Another judgment (10 Afs 221/2022 - 70), this time of the Supreme Administrative Court, involves the opposite point of view and concerns the question whether under a special provision of the Income Tax Act it is possible not to tax income up to the amount of directly related non-deductible expenses. A company recorded non-deductible interest expense relating to issued bonds (non-deductible due to not meeting the thin capitalisation test) and, at the same time, interest income from a loan agreement. According to the company, there was an immediate link between the bonds and the loan agreement and therefore also between the related interest; it argued that the receivable arising from the subscribed bonds and the payable from the loan agreement were offset, leading the company to believe that the relevant interest was also linked.

However, the Supreme Administrative Court disagreed with this approach. In its view, **although interest is an accessory to a receivable and, in principle, follows its fate, that does not necessarily mean that a direct link between receivables will always lead to a direct link between their interest**. That relationship must always be examined individually. It is not appropriate to assess the direct link solely based on whether the income and expense arise from the same legal title without considering the other circumstances of the case. The court also pointed out that in assessing the direct link, it is always relevant to consider whether the taxpayer would have received the income without incurring the non-deductible expense. In doing so, the purpose of the income and expense, the motives behind their creation, and their interdependence or interrelatedness may be taken into account.

Czech case law has been quite consistent in this area for a long time. If you decide to apply these special provisions of the Income Tax Act when preparing your income tax calculation, we recommend always analysing the situation thoroughly. In particular, consider whether you are able to prove a direct link between expenses and income in the light of the above case law and make sure to support your conclusions with appropriate reasoning, as it will come handy in a possible inspection by the tax authorities.

SAC on VAT exemption for intra-community supply

The Supreme Administrative Court (SAC) did not recognise the right to VAT exemption for a supply of goods to another EU member state, as there were doubts whether the goods had been supplied to a person registered for tax in another member state, and whether the goods had been transported to another member state at all. The SAC pointed out that it is in the interest of the taxpayer to obtain conclusive evidence, and that it is the taxpayer who bears the burden of proof and is obliged to prove that the conditions for exemption have been met.

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A taxpayer supplied frozen products to several EU countries and treated these supplies as exempt from value added tax. However, the tax authorities did not consider the CMRs to have been correctly filled in and true. Instead, the tax authorities claimed that the documents did not prove that the entities listed as customers in the tax documents were the actual recipients of the goods. In addition, in some cases the documents did not prove the actual course of transportation or gave untrue information, e.g., about the place of loading and unloading.

In their defence, the taxpayer explained all inaccuracies in the CMRs and provided the requested details. The taxpayer disagreed with the tax administration's view that the documents proved that the goods had been transported to another member state but did not prove that the declared customer was the recipient of the goods. The taxpayer argued that as the customers had paid for the goods, no other conclusion than that they had received the goods was possible.

The SAC stated that the mere payment for the goods does not prove that all the conditions for VAT exemption were met, especially not if payment was made from a bank account of an entity other than the declared customer. The taxpayer also did not have any documents proving that the goods had been ordered or received by a particular person in another member state. Yet, according to the SAC, the customer not being contactable by the local tax authorities cannot be held against the supplier.

The SAC noted that it is in the interest of the taxpayer to obtain documents which can prove in a relevant manner that the goods were actually delivered to another member state. It is the taxpayer who bears the burden of proof and is obliged to prove that the conditions for exemption have been met. As in this case the taxpayer did not themselves transport the goods to another member state, they should have made sure that they had credible evidence that the goods were delivered in the manner agreed. The main reasons the SAC did not grant the tax exemption were the substantial discrepancies in the submitted documents and that the taxpayer subsequently failed to remove these discrepancies or support their argumentation otherwise.

Case law

SAC on beneficial ownership of royalties

A recent Supreme Administrative Court (SAC) judgment dealt with beneficial ownership in the context of licensing agreements. In its decision, the SAC emphasised that an entity who is unable to freely decide on the use of collected royalty payments and is bound to hand over the majority of the funds received to another entity is not the beneficial owner.

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SAC 4 Afs 63/2022, the case under review, involved a dispute concerning the application of a UK-based company (in the taxable period in question, the UK was still a member of the EU) for exemption of income from royalties paid by a Czech company, and the fulfilment of the condition of beneficial ownership of the royalties by the UK company.

To understand the dispute and the judgment, it is important to note that the UK company was obliged to pay almost 95% of the funds received to other related parties.

The court looked into the actual economic benefit from the royalties and the entity's ability to use them freely. The UK company provided sublicenses to a Czech company and then passed on almost all funds received. The court concluded that the company was not the beneficial owner of the royalties because it was not free to make decisions about the use of the funds.

In its statement of grounds, the SAC emphasised that a beneficial owner of the royalties **must be able to determine their use and must not be contractually bound to transfer most of the royalties to another entity**. In terms of the economic benefit, it is crucial that the entity may dispose of the funds independently and use them as they see fit. This approach to the definition of beneficial ownership has potentially far-reaching implications for business practice and the taxation of licensing arrangements.

The judgment thus provides an important interpretation of the beneficial ownership of royalties, not least because its reasoning is based on the interpretations of beneficial ownership by the case law of the Court of Justice of the European Union.

SAC on application of essential costs

Several recent administrative court decisions have dealt with the question in what circumstances it is necessary to consider essential costs even if the taxpayer has failed to fully prove them. The issue was therefore addressed by an extended chamber of the Supreme Administrative Court (SAC).

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Essential costs are costs that must have been necessarily incurred in order to generate undisputed taxable income (e.g., a purchase of a car as a precondition for generating income from its sale). They are not explicitly defined in any provision of law. According to the prevailing professional consensus of the SAC, they have their place exclusively where tax is being assessed by the tax administrator using aids (according to whatever information and materials are available), i.e., in a situation where the standard method of determining tax (through evidence) fails.

The existing case law also agrees that tax may be assessed by the tax administrator using aids in cases of a "blackout of accounts or substantial part thereof". However, the opinions of the various chambers of the SAC differ as to what constitutes a substantial part of accounts and in what situation the essential costs should be applied. The issue was thus presented to the extended chamber, to provide a unified standpoint.

According to the extended chamber, it is unsustainable that once the taxpayer has failed to bear the burden of proof, the tax authorities would, with no further ado, step in with the duty to consider essential costs. Also, it is not right that the tax administrator should resort to using aids as the only possibility to take into account essential costs solely in cases where doubt has been cast over a substantial part of the taxpayer's account: a sufficiently high intensity of irregularities may be ascertained even for a rather marginal part of accounts.

The decision of the extended chamber thus appears to extend the scope of application of essential costs also to the determination of tax using evidence. The recognition of such expense shall be based on the taxpayer proving beyond reasonable doubt that the declared expense (group of expenses) actually occurred (must have been actually incurred), albeit under circumstances other than as shown in the relevant documents. Even in such a case, however, the taxpayer bears the burden of proof and must prove the new assertions in a credible manner. We expect that the scope of this burden of proof will be further clarified in the future.

Case law

CJEU: Is being a board member of a public limited company an economic activity?

The Court of Justice of the European Union has ruled that the activity of a Luxembourgian board member of public limited companies is not carried out independently if the member neither acts on their own behalf and responsibility nor bears the economic risk arising from their activity. This holds even if they freely determine the conditions of their work, receive fees, and are not hierarchically subordinated.

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In the present case, the CJEU dealt with whether a member of the board of directors was a taxable person and their remuneration for exercising the office was therefore subject to output VAT. The remuneration consisted of two parts - a fixed remuneration and a share in profit whose amount was decided by the general meeting. The person concerned was also a member of the board of directors of other public limited companies incorporated under the law of Luxembourg and performed multiple tasks in that capacity.

The Luxembourg tax authorities had referred preliminary questions to the CJEU as to whether this activity constituted an economic activity and whether it had been carried out independently within the meaning of the VAT Directive.

The CJEU assessed whether the remuneration fulfilled the characteristics of a consideration - in particular, whether there was a direct link between the remuneration and the person's activities and whether these were regular (both the activities and the remuneration). The CJEU found that the fixed part of the remuneration fulfilled the characteristics of a consideration. As for the share in profit, it would have to be clear whether the remuneration would be paid even if the company did not make a profit. To determine whether the activity was an independent economic activity, the CJEU noted that it is necessary to determine whether there is a relationship of subordination in the performance of the activity (whether the board member performs the activity in their own name, on their own behalf and responsibility, and whether they bear any economic risk).

According to the CJEU, there was **no hierarchical subordination relationship** in the situation under review. To assess 'acting in their own name, on their own behalf and responsibility', the CJEU referred to the division of responsibilities between the members of the board of directors on the one hand, and the company on the other hand under Luxembourg law, which expressly prohibits a member of the board of directors from assuming personal liability for the debts of the company. If a director does not act under their own responsibility, they instead act on behalf of the board of directors and, in general, on behalf of the company, while they must act in the company's best interests. A board member providing their expertise and know-how to the board of directors **does not bear the economic risk associated with their own activity** – the Company itself will have to face the possible negative consequences of decisions taken by the board of directors and therefore bears the economic risk arising

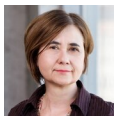
from the activities of the board members. The fact that a board member’s remuneration depends on the company's profit has no effect on this, as the participation in the company's profits cannot be equated with assuming the company's risk of profit and loss.

According to the CJEU, the activities of the Luxembourgian member of the board of directors of public limited liability companies do not constitute an independent economic activity as long as the member does not act on their own behalf and responsibility and does not bear the economic risk arising from their activities. This activity is therefore not subject to VAT.

In brief

24 News in Brief, March 2024

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



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DOMESTIC NEWS

- Government Decree No. 17/2024, amending the previous Decree No. 463/2022 Coll., on the determination of prices of electricity and gas supplied in an extraordinary market situation for losses in distribution and on compensation of losses provided for the supply of electricity and gas at fixed prices, has been published in the Collection of Laws.
- Amendment to Government Decree No. 36/2023 Coll., on the format and template of submissions using prescribed forms for the levy on surplus market revenues, has been issued under No. 18/2024.
- On 1 April 2024, the Motor Third Party Insurance Act including its accompanying law will come into effect. The new regulation responds to the relevant EU Directive and introduces key changes to the legal framework relating to third party liability insurance (No. 30/2024 and 31/2024 Coll.).
- The following regulations have been published in the Collection of Laws: amendment to Decree No. 480/2020 Coll., on the use of roads subject to time-based tolls (under No. 35/2024); Government Decree No. 40/2024 amending Decree No. 240/2014 Coll, on time-based tolls, toll rates, toll discounts and the procedure for applying toll discounts; and amendment to Decree No. 470/2012 Coll., on the use of toll roads (under No. 41/2024).
- A bill on investment companies and investment funds is heading to its third reading. The main proposed measures are the regulation of unlicensed managers and some minor areas where the market or the CNB requires clarification. The bill also includes an amendment to the Income Tax Act and some other laws (see separate article).
- The draft amendment to the Company Conversions Act will be discussed by the chamber of deputies in its third reading. The main objective is to incorporate into Czech law Directive (EU) 2019/2121 of 27 November 2019 amending Directive (EU) 2017/1132 as regards cross-border transfers of registered offices, mergers, and divisions. The draft also removes certain other changes in response to practical experience with company conversions and includes a minor amendment to the Income Tax Act.
- The current list of countries on the EU list of non-cooperative jurisdictions for tax purposes, approved by the EU Council, has been published in Financial Bulletin 3/2024.
- On 20 February 2024, a treaty between the Czech Republic and Montenegro on the avoidance of double taxation in the field of income taxes was signed in Podgorica, with the expected effectiveness from the beginning of 2025. After that, the existing treaty between the Czech Republic, Serbia and Montenegro will cease to apply to Montenegro.

FOREIGN NEWS

- In February, several member states (the Czech Republic and, e.g., Ireland, Germany, Poland) released their reasoned opinions on the BEFIT proposal and expressed their concerns. The Czech Republic's position versed by the senate argues, among other things, that BEFIT will increase the administrative burden on public administrations and businesses and interfere with the member states' competence in direct taxation. Other member states have voiced similar concerns.

- The General Affairs Council has decided to remove the Bahamas and the Turks and Caicos Islands from the EU's list of non-cooperative jurisdictions for tax purposes. Following this latest revision, the list now includes the following twelve jurisdictions: American Samoa, Anguilla, Antigua and Barbuda, Fiji, Guam, Palau, Panama, the Russian Federation, Samoa, Trinidad and Tobago, the US Virgin Islands, and Vanuatu.

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