Tax & Legal

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December 2019

Editorial

The government has approved a digital services tax for multinational internet groups the likes of Google or Facebook. At a rate of 7%, the tax should add up to five billion of Czech crowns to the budget next year. This is the government's response to the development in the European Union, where, after no consensus was reached on a central policy, every state has been left to adopt relevant laws on an individual basis. To compare – Austria, for instance, is introducing a digital tax of 5%, with Italy and France both choosing a 3% tax. Slovakia has decided to wait for a centralised solution.

This year once again, Czech legislators failed to debate important bills on time, not making life any easier for businesses trading within the EU, especially those using consignment stock arrangements. The amendment to the VAT Act implementing quick fixes will only enter into effect from the second quarter of 2020, although the revised VAT Directive will already apply from 1 January.

In other news, be weary of what you download from a work computer. In a recent case, the Supreme Court sided with an employer and concluded that unlawfully downloading corporate data on a flash disc can be viewed as an especially gross breach of an employee's duties. Thus, the court confirmed the rightfulness of the immediate termination of employment.

Advent started and the shopping frenzy around us is bound to get worse. Let's call to mind what we often say at times like these, but usually do not act upon: Christmas should be, above all holidays, a time of peace, quiet, and love. So, why not stay at home with our loved ones, go for a walk or attend a cultural event together?

I wish you a happy read and less stress in the preholiday period.

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Government approves digital services tax

The government submitted a bill introducing a 7% digital services tax to the Chamber of Deputies. The tax will apply to companies that are part of corporate groups generating a turnover of more than EUR 750 million and with a tax base relating to taxable digital services rendered in the Czech Republic exceeding CZK 100 million. The government expects that the act will enter into effect in mid-2020.

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The bill divides taxable services into three basic groups: the performance of targeted advertising campaigns, the use of multilateral digital interfaces, and the provision of user data. Taxable services are services provided via a digital interface, i.e. any software such as a website or an application accessible to users. The user is any legal entity or an individual or a unit without legal personality, accessing a digital interface using technical equipment. Where such services are rendered via technical equipment located in the Czech Republic, the provision of such services is treated as taxable, giving rise to a tax liability. A primary clue is the location of the equipment's IP address.

The provision of a targeted advertising campaign shall mean the placement of a targeted campaign on a digital interface and the provision of accessory services. The use of a multilateral digital interface shall mean allowing for the conclusion of a transaction among multilateral digital interface users to facilitate the delivery of goods, the provision of services, or the mere provision of user access to a multilateral digital interface. The provision of user data shall mean the provision of a set of data on users collected or created based on their activity on digital interfaces. A partial tax base will be calculated for each individual group of services while focusing on the extent to which the taxable services are provided in the territory of the Czech Republic.

The bill specifies a minimum threshold for the taxation of specific digital services. For the provision of targeted advertising campaigns and the provision of user data, the sum of payments for a particular service rendered in the Czech Republic must exceed CZK 5 million. The use of multilateral digital interfaces will be liable to digital services tax if the number of user accounts on the interface exceeds 200 thousand. Corporate groups whose sum of payments for taxable services rendered in the EU member states, Switzerland, Norway and Island accounts for a maximum of 10% of their total revenue from these states should be excluded from the law's applicability. The bill also determines other exceptions.

The taxable period shall be the calendar year. After registration, taxpayers will have to pay monthly instalments and keep records of their digital services, sorted by individual deliveries of taxable services as needed for the preparation of tax returns.

The law should be in harmony with the digital economy taxation principles within the EU and the OECD. Its applicability will be time-restricted: the last taxable period when the law should apply will be 2024.

Quick fixes: consignment stock arrangements from January 2020?

The amendment to the VAT Act implementing quick fixes will not be effective from 1 January 2020, since the Chamber of Deputies is yet to discuss it even in its first reading. So how should Czech VAT payers involved in the intra-community supply and acquisition of goods proceed starting January 2020? Can they make use of the direct effect of the VAT Directive and proceed in accordance with it? Problems will arise both in situations in which Czech payers withdraw goods from their European suppliers' consignment (call-off) warehouses located in the Czech Republic, and in situations in which Czech entities own inventories in a consignment (call-off) warehouse in another member state.

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An amendment to the VAT Act (Print 572) is expected to be in effect from the second quarter of 2020. The question arises what this delay in the implementation of the EU directive means for Czech VAT payers.

This mainly affects Czech payers who withdraw goods from their European suppliers' consignment warehouses located in the Czech Republic. The amended directive will be in effect as early as from 1 January 2020. From the same date, amendments relating to quick fixes may also be effective in legislations applicable in the member states in which individual suppliers operate. Czech entities withdrawing goods from call-off warehouses might therefore encounter problems with their suppliers who may ask them to proceed in accordance with the amended EU regulations already from the beginning of the new year. This should be allowed by the EU directives' direct effect concept.

The inverse scenario under which European customers may ask suppliers to proceed in accordance with the amended regulations may cause even more problems. This involves situations in which Czech entities own consignment warehouses in the territory of another member state with inventories on stock intended for specific European suppliers. In such cases, we recommend contacting the European customers as soon as possible and mutually agreeing on how they should proceed from 2020. From a technical viewpoint, it will not be possible to meet the requirements for the correct reporting of the transfers of goods into consignment warehouses (and subsequent sales) in EC Sales Lists in the manner required by the quick fixes. It is therefore worth considering whether the transition to a new system of consignment stock arrangements should not be commenced only after the Czech amendment enters into effect.

It should also be considered that from 1 January 2020, VAT payers should proceed in compliance with amended and directly applicable Council Implementing Regulation (EU) No. 282/2011. The regulation includes, inter alia, a rebuttable presumption to prove the transport of goods to another member state, according to which transport has been proven if the person claiming the tax exemption has the prescribed documents at their disposal.

Subsidies for large businesses after 2020

In the 2021-2027 period, the Competitiveness Operational Programme (COP) will follow up upon the Enterprise and Innovations for Competitiveness Operational Programme (EIC OP), managed by the Ministry of Industry and Trade. The programme will primarily focus on providing aid for digitalisation, research and development, small and medium-sized enterprises, and projects with positive environmental impact. The programme is funded from the European Regional Development Fund (ERDF). Funds available for allocation amount to EUR 7.24 billion.

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This COP will again have several priority areas: in addition to technical assistance and business development support only designed for small and medium-sized businesses, there will also be programmes for large businesses. Key priorities for them should be as follows:

- Enhancement of business performance relating to research, development and innovation, and digital transformation – support provided to implement advanced technologies and strengthen research and development capacity.
- Shift towards low-carbon economy – support of energy generated from renewable resources, green infrastructure, and energy efficiency measures.
- More effective resource management – response to climate changes, catastrophe prevention programmes, and transition to circular economy.
- Digital infrastructure development – support to enhance digital interconnection.

Based on the above, we may conclude that programmes similar to the current Potential, Low-Carbon Technologies, Energy Saving and Renewable Energy Sources programmes will be available to businesses. Almost 80% of the funds to be allocated should be invested in the above priorities, which is a significant amount for distribution.

The programme is still in its development phase; consequently, we can only speculate about its final design, criteria, deadlines, and restrictions for large businesses. More details in this respect are expected to be gradually made available during the course of 2020, after conclusion of the final agreement with the European Council.

New government programmes for migration of foreign workers

Starting in September 2019 and in connection with changes to the Act on Residence of Foreign Nationals in the CR, government programmes facilitating the hiring of foreign workers have also been under revision. The most crucial change is the simplification of the entire process: the non-transparent and heterogenous programme system has been replaced with three new individual programmes, categorised by profession. Criteria for the inclusion of employers in the programmes have also been softened, so that now, e.g., a smaller number of required workers is acceptable and some previously mandatory appendices to documentation are no longer needed.

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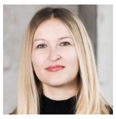

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Key and Scientific Personnel Programme

This programme replaces two former programmes, Fast Track and Welcome Package, and is designed for top corporate positions involving managers, specialists, statutory body members and interns. The programme's indisputable advantage is a shorter approval period for employee card applications, reduced from 60 to 30 days. It also allows for the relocation of workers together with their families, which in our experience many candidates require. Under the programme, it is also possible to replace part of the mandatory documentation with an employer's affidavit.

Highly Qualified Personnel Programme

The second programme is a combination of the Special Procedures for Highly Qualified Employees from Ukraine and India projects. The programme's applicability has been significantly extended to cover almost 30 countries (such as Turkey and Belarus) and allows for the inclusion of applicants' family members. Like the former programmes, it focuses on highly qualified personnel, i.e. applicants must be in CZ-ISCO classification positions 1 to 3 (i.e. managers, specialists and professional personnel), and it is possible to replace some of the required documents with the employer's affidavit, as in the case of the programme above.

Qualified Personnel Programme

The third programme replaces three former programmes: Special Treatment Regime for Qualified Personnel from Ukraine; Regime for Other States; and Special Procedures for Personnel from Agriculture, Food Industry and Forestry from Ukraine. The programme's applicability has been extended to other states such as Belarus, Montenegro, India, Kazakhstan and Moldavia. Like in the past, candidates in CZ-ISCO classification groups 4 to 8 can be included in this programme (i.e. mainly manual workers in services, sales and manufacturing).

To be included in the above programmes, employers must apply with a guarantor, always for a period of one year. During this time, employers may use the above simplified regimes to obtain the necessary work and residence permits for candidates meeting the individual programme's criteria. The programmes offer several advantageous novelties, such as the automatic allocation of dates for filing a foreign national's application for necessary permits, which is extremely helpful especially when dealing with certain embassies, e.g. in Ukraine or India, that are traditionally overloaded. The government sets annual quotas to determine the number of workers that can be relocated within the given programmes, in turn limiting the number of applications that can be filed with individual embassies.

Demand for foreign personnel varies; historically, the biggest demand has been for workers from Ukraine. We have recently noted increased interest in qualified candidates from India, the Philippines, Mongolia, Kazakhstan and Belarus. The above programmes may help tackle formalities even for these countries. However, it is necessary to proceed quickly, as this year's quotas for the three last mentioned countries have already been exhausted. The quotas for the next year have not yet been published.

Changes to distribution and payment of corporations' profit and other components of equity

Rules for the distribution and payment of profit and other components of equity should change substantially from 2021 through an amendment to the Act on Corporations, which has recently been submitted by the Chamber of Deputies to the Senate. The new rules aim not only to remove existing deficiencies and remedy the imperfect transposition of EU legislation but also respond to latest developments in case law.


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One of the most significant changes to the distribution and payment of funds is the implementation of rules for the use of accounting documentation, following a recent judgment of the Supreme Court (ref. no. 27 Cdo 3885/2017). According to the draft amendment, it will be possible to use ordinary or extraordinary financial statements approved by a corporation's supreme body as a basis for the distribution of funds until the end of the accounting period following the accounting period for which the financial statements were prepared.

Certain rules should also be harmonised to apply to all of a corporation's funds regardless of their origin. The amended law should explicitly prescribe that the distribution of both profit and other own resources can only be carried out based on ordinary or extraordinary financial statements. The amended law should also specify uniform balance sheet tests, i.e. methods of calculating the maximum amount for distribution and payment, for joint stock companies, limited liability companies and cooperatives. These will also be terminologically aligned with accounting legislation. However, opposed to other components of equity, profit will continue to be subject to a slightly different statutory regime.

The amendment also tightens the rules for refunds of paid profit shares. Members of limited liability companies will no longer be protected from the duty to refund the paid profit shares by their good faith that the statutory conditions for profit share payments have been fulfilled. The good-faith argument will only be preserved with respect to joint stock companies. Shareholders will have to refund their shares of profit and other components of equity only if they knew or must have known that the statutory conditions upon the payment have been violated.

Another innovation is, for example, the explicit specification of cases in which it is necessary to refund the paid advance for a profit share, or the implementation of protective measures against disguised profit payments.

In our opinion, the proposed legislation is not without deficiencies. Questions arise in particular regarding, e.g., the explicit exclusion of the application of the rules for the distribution and payment of profit and other components of equity to decreases in the registered capital. It would certainly not be desirable for a corporation's bodies aiming to decrease a corporation's registered capital not having to pay attention to the corporation's economic performance, thereby bringing financial difficulties or even bankruptcy onto their entity. Similarly controversial is also the new rule according to which the unpaid share of profit or other components of equity of joint stock companies, limited liability companies and cooperatives should be, without exception, transferred to retained profits if an insolvency test is not met. In this manner, resources not deriving from profit would be transformed into profit, resulting in a change to the statutory regime for treating these funds.

Obviously, we may expect relatively extensive changes in the distribution and payment of corporations' profit and other 'own resources', which may significantly affect one of the shareholders'/members' fundamental rights. The amendment to the Act on Corporations is currently with the upper chamber of parliament.

Another chance for large amendment to the Labour Code

A large draft amendment to the Labour Code from August last year has for a long time seemed forgotten. This October, however, a turning point came when the Ministry of Labour and Social Affairs disclosed another large draft amendment. At the same time, representatives of the government coalition, trade unions, and employers have also declared their interest in making the draft's path through parliament as short as possible. That is why, in mid-October, they signed a gentlemen's agreement declaring their joint support. The extensive amendment to the Labour Code will therefore get another chance, even if in an amended form.

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Conceptual adjustments to the treatment of vacations remain the amendment's notional flagship. According to the amendment, an employee's weekly working hours should form the basis for assessing vacation in hours, which will be especially fairer for employees working in shifts with varying lengths.

Linked to the change in the overall vacation concept is also the proposed modification of vacation reductions. Whereas today, employers may reduce an employee's vacation by one to three days for an unexcused missed shift, pursuant to the draft, it should only be possible to cut employee vacations by the number of working hours actually missed.

A job-sharing concept has also made it into the new amendment. Two or more employees should be able to share one job and take turns within working hours that they themselves schedule to perform the job. The job sharing must be agreed in writing between each employee and the employer and the shorter working hours of individual employees sharing one job may not in aggregate exceed statutory weekly working hours.

The large amendment should also respond to the practical problems associated with the delivery of written documents to employees. For example, as regards mail delivery, it will no longer be necessary to hunt down employees at home or elsewhere to properly deliver written documents, as it should suffice that the employer attempts to deliver the document at the workplace.

The amendment also cancels the employer's duty to issue a confirmation of employment for an employee where an agreement to perform work has been terminated (excepting agreements subject to the participation in the sickness insurance scheme or garnishment of a portion of wages). The draft also increases the amount of one-off compensation paid to an employee's surviving dependants to at least twenty times the national economy's average wage.

In contrast, the tripartite has not been able to agree on the setting of a mechanism for increasing the minimum wage on an automatic basis. This controversial point has therefore been excluded from the large amendment. The minimum wage will therefore continue to be determined by government decree and changed occasionally when necessary.

The effort to adopt an extensive amendment to the Labour Code began in the last parliamentary term, but the deputies’ chamber in its previous composition did not have time to pass it. And the bill’s position in the current term is not easy either. After a year of discussions since the publication of its second version, the amendment’s wording, very much a compromise, was included in a bill primarily regulating the transposition of the EU Directive on the Posting of Workers. The amendment should enter into effect on 1 July 2020, or 1 January 2021 where certain selected provisions, such as those relating to vacation, are concerned. Will the amendment be discussed and approved in due time? We just have to wait and see…

BEPS 2.0: Revolution in international taxation on the horizon

Following up on the Base Erosion and Profit Shifting (BEPS) initiative, the OECD Secretariat published a document containing a new proposal for a unified and global approach to the taxation of the digital economy, BEPS 2.0, introducing a new method for the allocation of profits among states as well as a proposal for the existence of a minimum tax rate. The initiative aims to achieve consensus on the matter among the states before the end of 2020. The proposal in fact departs from the arm's length principle (i.e. how much would be paid for services or goods between unrelated, independent parties) and attempts to allocate profits by formula.

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BEPS 2.0 is a follow-up of the OECD's Base Erosion and Profit Shifting (BEPS) project of 2015, whose outcome was a set of recommendations of how to reduce aggressive tax planning. Some recommendations were directly implemented by the EU through the Anti-Tax Avoidance Directive (ATAD). The current initiative primarily deals with challenges associated with digitalisation and intends to distribute certain profits of multinational corporations among the states and allocate tax revenue to the countries in which the users and customers of these corporations reside. The new profit taxation principle would thus not derive from the physical presence of companies in individual countries (the existence of permanent establishments), but a certain revenue threshold in a given jurisdiction would be used.

BEPS 2.0 has two main pillars: Pillar 1 describes a unified approach for the allocation of taxing rights and for the revision of profit allocation among the countries; Pillar 2 develops rules giving jurisdictions the taxing rights where primary taxation does not occur in other jurisdictions or where taxation is set at an effective tax rate lower than the minimum tax rate.

The OECD's recently published document deals with Pillar 1, i.e. applying a unified approach to highly digitalised business models and consumer-facing businesses. Its application to other industries is yet to be discussed; however, it should be restricted by a worldwide annual turnover of EUR 750 million.

In short, this initiative offers a new solution for the re-allocation of taxing rights among jurisdictions in exchange for higher legal certainty for all parties. The unified approach means that a portion of the deemed residual profit, i.e. profit above a certain threshold, is allocated among other jurisdictions using a formulary approach (the profit will be derived from a corporation's consolidated financial statements). Simultaneously, a fixed return should be established for certain baseline or routine marketing and distribution activities in a jurisdiction in accordance with existing international taxation rules. And, finally, compensation for other functions in a jurisdiction should be determined based on the existing arm's length principle.

In early November, a public consultation document dealing with Pillar 2 was published. Agreement on the final BEPS 2.0 framework is expected at the end of January 2020, while consensus among the states may become a reality at the end of the same year. We believe that this initiative should be monitored very carefully; it may happen that no consensus among the OECD countries is reached, resulting, as in the digital economy taxation case, in a number of uncoordinated unilateral local initiatives potentially leading to double taxation. On the other hand, if this initiative is successfully implemented, a shift from the arm's length principle towards the formulary allocation of profits could also affect other international taxation areas.

Due managerial care – a new perspective?

The European Union is preparing a legal regulation aiming to put the finance sector at the forefront of efforts for a greener and cleaner economy. The new regulation will promote sustainable projects that may be loss-making over long periods with their social value only becoming apparent after several years. Will this also necessitate a change in the concept of fiduciary duty/due managerial care requiring managers to generate profit for shareholders?

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The EU regulation now being prepared establishes a framework to promote sustainable investments and follows from the Paris Agreement on Climate Change and the UN 2030 Agenda for Sustainable Development. In these documents, the European Union as well as the governments of most countries undertook to fulfil objectives aimed at a more sustainable economy and society. The European Commission understands that without engaging the private sector it will not have sufficient capital to fulfil these objectives. It is thus logical to engage the financial sector, in particular banks, which by their nature generate most of the private money in circulation and allocate it through loans.

The new legislation aims to redirect private capital to green projects. The regulations now being prepared should motivate investors to be more aware of the environmental impact of their business activities and prioritise 'clean' investments over 'dirty' ones. For this purpose, the regulation, among other things, introduces a classification of individual investments by their sustainability, so that investors may also assess their environmental impact.

Beyond any doubt, one issue with green projects is that they tend to be riskier and may not generate profit in the short-term, although their sustainability and social value should show in the long run. However, by including loss-making green projects in their portfolios, managers would be in breach of their fiduciary duty/duty of due managerial care under which they have to generate profit for their clients and recipients.

In this respect, the regulation now being prepared may not be the last one. In fact, green investment aspects have never been discussed on such a scale before. It is thus to be expected that this trend will continue at the highest political level. And regulations involving other private entities, not just financial institutions, are bound to follow.

But is it possible within just years to shift the limits of due managerial care so far away from investors' and shareholders' interests and towards environmental protection and sustainability that assessing projects' profitability would become secondary to assessing their sustainability?

The present concept of due managerial care obliges the statutory body of a corporation to act with due care, necessary knowledge and loyalty. The European Commission has already proposed also including environmental, social and administrative criteria in the mandate of European supervisory bodies. Furthermore, the newly appointed European Commission headed by von der Leyen aims to make the EU a worldwide leader in environmental protection. It is thus likely that each new legislative proposal of the European Commission will reflect these criteria, which will then also have to be taken into consideration by the statutory bodies of private companies when making their investment decisions. An informed and ‘right’ decision should thus not be driven solely by the desire to make as much money as possible year on year, but rather by the effort to invest in projects that are sufficiently green and sustainable. The question remains when we will see a change in the concept of “acting in the justifiable interest of the corporation” as we know it from the present wording of the Corporations Act.

Unauthorised download of corporate data on a flash disc a particularly gross breach of employees' duties

The Supreme Court sided with an employer who had immediately terminated the employment of an employee who without authorisation had downloaded 2.2 GB of work-related data on his flash disc. This is good news for all employers, though it must be emphasised that specific circumstances should always be reviewed on a case-by-case basis, and the court's conclusions in the case in question cannot be applied universally.

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The employee sought the invalidity of an immediate termination of employment by claiming that he had been authorised to handle the employer's data as part of his job with the employer. The district court sided with the employee, having determined that employees indeed received flash discs from the employer and were authorised to download data even without the employer's consent. In the court's opinion, the employee's intention to leak or sell the data was not proven.

The Municipal Court in Prague reversed the decision, arguing that while the employee had been authorised to use the flash disc without the employer's consent, this use was to be solely limited to the transfer of data between a stationary computer and a notebook. In the case in question, however, it was proved that the employee did not download the data for work-related purposes. Therefore, in the court's opinion, the employee had breached his duties, and the immediate termination of his employment remained valid.

In its appellate review, the Supreme Court mainly dealt with the intensity of the breach of work duties, i.e. whether the case involved a particularly gross breach of duties where the employer cannot be reasonably requested to continue employing the employee, not even for the usual termination notice period. The court considered the employer's business activity (the employer was a bank), the employee's position (the employee was in a position where he could access sensitive data), and the clarity and strictness of the employer's instructions and internal policies regulating the handling of data. The court also reflected on the employee having downloaded the entire content of his mailbox, including sensitive data concerning the credit and other activities of the employer and its clients. The Supreme Court then arrived at the same conclusions as the Municipal Court in Prague, dismissing the employee's action for annulment of the immediate termination of employment, with final and conclusive effect.

Notwithstanding the above, it is advisable that employers always proceed carefully when resorting to immediate terminations of employment. The intensity of the breach in question may be subject to review by a court, which will then have to consider, for instance, an employee's personal circumstances, the office they hold, their attitude towards working duties so far, the timing and circumstances of the breach, the extent of employees' fault, the manner and intensity of a breach of concrete duties, the consequences of the breach, i.e. whether the employee caused any damage to the employer. It might be especially difficult for the employer to estimate in advance whether there is a chance of defending the immediate termination in court, if necessary. In this respect, detailed knowledge of recent case law is the only guidance.

Case law

Data leaks could cost you dearly

Last year, one of the historically highest penalties for breaches of personal data protection, CZK 1.5 million, was imposed on a well-known e-shop that had failed to protect its customers' personal data including passwords to their user accounts. This year, the same e-shop faces another consequence of this failure: an individual customer has successfully claimed in court compensation for non-proprietary loss caused by the data leak.

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The e-shop reported a data leak in 2017. Two months later, an individual customer filed an action for CZK 125,000 as compensation for a breach of privacy. The first-instance court did not award the compensation in full, on the grounds that some of the plaintiff's personal data leaked had also been published on the internet by the plaintiff himself, and that he could not hold the e-shop accountable for his own repeated use of weak passwords to access various services. However, the court did award the plaintiff reasonable satisfaction of CZK 10,000, on the grounds that he had to change the passwords that had been leaked.

Recently, the appellate court decided that while the above arguments were, to a certain degree, valid, the plaintiff was indeed entitled to damage compensation in the amount awarded, but not on the grounds of harm consisting in the need to change the passwords, but rather on the grounds of an infringement on the right to informational self-determination, part of the right to privacy guaranteed by the constitution and comprising the right to decide to whom and in what manner a person will provide private facts and information. In its decision, the court also took into consideration the significant market position of the e-shop being sued, and the extent of data controlled. The court also emphasised the preventative and punitive purpose of its decision.

The judgement has now entered into effect, and the e-shop has stated that it will respect it. At the time of publishing the appellate court's decision, the court had not been aware of any other similar cases pending. However, since the claims of other potentially injured parties have not yet been statute barred, it is possible that the successful lawsuit may inspire others. On the other hand, in the Czech legal environment, success in a single case does not necessarily mean the success of other potential lawsuits, especially where the court's arguments are problematic or controversial.

Any similar cases will be strongly affected by the new legal regulation of class actions currently being prepared. The new regulation should make it possible for injured parties to assert their claims collectively, through a joint representative. It is thus to be expected that the number of lawsuits will grow. If successful, they may, in their final effect, do more harm to personal data controllers than penalties imposed under the GDPR.

As for the record penalty, the e-shop has challenged it in an administrative court proceeding, which is still pending.

Purchased IT services from a transfer pricing perspective

In a transfer pricing case, the Supreme Administrative Court (SAC) opined on the role of comparative analysis in evidentiary proceedings. The court, among other things, accepted the technique of assessing the adequacy of costs by comparing the total amount of purchased intra-group services with a taxpayer's turnover.

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In its judgement 5 Afs 341/2017-48, the Supreme Administrative Court (SAC) dealt with supporting the arm's-length price of IT services purchased by a taxpayer to operate an e-shop. The tax administrator focused on reviewing the arm's-length ratio of the IT service costs of comparable entities to their sales; based on this criterion, the tax administrator determined a difference in the prices of services applied by the taxpayer. The taxpayer argued that the tax administrator did not deal with the prices, e.g. hourly rates, but with the cost-to-sales ratio, where the comparability of conditions must be carefully reviewed; the taxpayer also argued that all circumstances of the case had not been taken into account, namely the contractual conditions, business strategies, and economic circumstances. The regional court had agreed with this. The tax administrator then filed a cassation complaint to the SAC.

In a rather extensive reasoning of its judgement, the SAC analysed the individual factors of comparability: properties of assets and services, functions performed, contractual conditions, economic circumstances, and business strategies. The SAC concluded that the tax administrator had erred in comparing business strategies, as this assessed the taxpayer as an established enterprise, while not carrying out any such assessment of circumstances for the comparable entities. The SAC thus found the tax administrator's cassation complaint unfounded.

As to the assessment of costs itself, the SAC commented that *"when assessing external services comprising the administration and maintenance of an IT environment used for e-commerce, it is not relevant in which specific goods the comparable entities are trading, as, according to the complainant, websites and e-shops are managed using the same methods and processes as in the case in question..."* The court thus found the tax administrator's reasoning based on comparing the total costs to the company's turnover logical and conclusive.

In the light of the above, it is advisable not to underestimate the role of comparative analysis as the main pillar of evidentiary proceedings in supporting transfer prices.

SAC: tax-exempt sale of shares covered by tax-exempt dividend payment an abuse of right

In a November judgement, the Supreme Administrative Court (SAC) confirmed that a transaction consisting of a tax-exempt sale of shares with the subsequent payment of the purchase price using a tax-exempt dividend had no economic grounds other than obtaining a tax advantage. Based on the application of the abuse of right doctrine, the SAC confirmed the additional assessment of withholding tax on the dividend paid.

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The case in question involved a series of transactions. First, a joint-stock company was formed by a demerger by spin-off, to which in effect solely cash in excess of CZK 200 million was transferred. Then the shares were sold by the individuals holding them to an unrelated corporate entity; since the time test was met, the proceeds from the sale of shares were tax exempt. In the next step, the sold company paid dividends to the new owner; since the formal conditions of a parent-subsidiary relationship (holding at least a 10% stake for at least 12 months) were met, the dividend payment was to be exempt from withholding tax. The dividend paid was then used to pay the purchase price to the original shareholders.

The SAC admitted that in the case in question, the Income Tax Act had been complied with. However, the court also assessed whether the transaction had had any economic grounds and whether the application of tax exemption of dividends had been, in this specific case, in accordance with the purpose and meaning of the law. In this respect, the court concluded that there was an abuse of right, as the main objective of the transactions (namely the sale of shares and the subsequent payment of dividend) was to obtain a tax advantage in a form of a *de facto* tax-exempt payment of dividend to individuals.

In the assessment of the case, several circumstances were considered. The SAC namely pointed out the time sequence of the individual steps: the demerger by spin-off and the formation of the new joint-stock company occurred at the end of May 2010, and the shares were sold at the beginning of June, with the decision on the dividend payment adopted on the same date. The court also pointed out that the sale of shares was effected at a loss of CZK 2.5 million, which made no economic sense in a situation when the company's assets comprised solely cash. More likely, this 'loss' was to serve as commission for the company that realised the transaction. Although the tax administrators failed to prove a connection between the buyer of the shares and the original shareholders, it was clear from the circumstances of the case that the purpose of both parties' actions was to obtain a tax advantage, according to the SAC.

Once the SAC concluded that there indeed had been an abuse of right, the tax administrator had to determine to whom the additional tax should be assessed. In the case in question, the abuse of right involved two transactions: the sale of shares, and the payment of dividends. The aim of the abuse of right doctrine is restitution, meaning the elimination of the undesirable status of obtaining an unjustified tax advantage. However, the specific manner of recovering such a tax advantage is in the tax administrator's hands and depends on the circumstances of the case. The tax administrator thus rightly assessed the additional withholding tax on the dividend to the subsidiary as the tax payer.

Although generally nothing prevents taxpayers from minimising their tax liability, obtaining a tax advantage cannot be the main purpose of a transaction or a series of transactions. While the burden of proof that the conditions for invoking the abuse of right concept have been met lies with the tax administrator, taxpayers should have sufficient evidence available to support the economic grounds of transactions providing a more advantageous tax treatment. The abuse of right doctrine, historically formulated by the courts' decision-making practice, has now been explicitly stipulated in the Tax Procedure Code. Only time will tell whether we will see more such cases in the future.

Breaches of corporate representation rules and their consequences

In practice we often see that according to the entry in the Commercial Register, at least two statutory representatives should act jointly on behalf of a company, while in reality, contracts are signed by just one of them. Is a contract executed in this manner binding? If so, for whom – the company, or its statutory representative who has clearly exceeded their authority to represent? A recent Supreme Court (SC) judgement answers this question.

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The case in question involved a violation of the two-person (four-eye) rule that followed from the company's memorandum of association and should have been properly recorded in the Commercial Register as the manner of acting on behalf of the company. Under these circumstances, the company shall not be bound by the contract, as it was not duly represented in concluding it. If the company wishes to take up the effects of the contract, it must subsequently approve its conclusion, without undue delay after it has learned of the excess of the authority to represent. The decision on such a subsequent approval falls under the business management, and is usually within the powers of the statutory body as a whole: if there is a collective statutory body, the decision shall be passed by a majority of votes present; if each statutory representative is an individual statutory body, the consent of a majority counted from all statutory representatives is required. These rules apply unless the memorandum of association stipulates otherwise.

In general terms, however, any person authorised to represent the company in the matter at hand may express the company's will on its behalf, i.e. conclude a contract from which rights and obligations will ensue for the company. This means that, apart from members of statutory bodies, a contract may also be sanctioned by proxy holders, by authorised representatives to the extent of their authorisation, or by employees to the extent of their authorisation to carry out certain activity within the operation of a business enterprise. No decision on subsequent approval is required here if the authorised representative has duly expressed the will to be bound by the contract on behalf of the company. Such expression of will may also take the form of performing the obligations under the contract. However, for the performance of obligations to have the effect of expressing the will to be bound by the contract, the company has to be duly represented by an authorised person or persons, who, for instance, supportably make a payment or deliver goods.

If the conclusion of the contract is not sanctioned, it shall be binding directly upon the representative who had exceeded their authority to represent. The other contracting party may demand of them to perform what has been agreed or to compensate them for damage incurred, however, only as long as the other party was in good faith as to their authority to represent. If it is clear from the entry in the Commercial Register that at least two statutory representatives shall act jointly on behalf of the company, there is no good faith, as the other contractual party could and should have checked the representative's authorisation, and, had they done so, they would have known that the statutory representative was not authorised to act independently on behalf of the company. Therefore, a contract thus concluded will not be binding upon the company or its statutory representative.

The SC also emphasised that it is necessary to differentiate between the subsequent approval of an excess of the authority to represent, and successive acts by members of a statutory body who attach their signature to the contract one by one; this is quite common, as the time and place of signing a contract does not always suit all statutory body members. If it is clear from the beginning that the contract will be signed in this manner to comply with the two-person rule, this does not constitute an excess of the authority to represent. Nevertheless, the company's will to conclude the contract will only be expressed once the last of the requisite signatures is attached to it. In contrast, where the subsequent approval of an excess from the authority to represent is involved, the company shall be bound by the contract already from the date when it was signed by the statutory body member exceeding their authority to act (and by the other contractual party).

Financial administration's employee bonuses for additionally assessed tax criticised by SAC

The Supreme Administrative Court (SAC) commented on the possible bias of tax officers who had assessed additional tax for errors concerning research and development allowances. Early in 2016, the financial administration issued rules on awarding employee bonuses depending on the amount of additionally assessed tax. Although the SAC did not ascertain the tax officers' bias because the rules on awarding the bonuses had only been issued at the end of the tax inspection, the judgment is still worth mentioning.

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One of the objections raised by a taxpayer in a cassation complaint was the bias of the tax officers who carried out the tax inspection. The taxpayer referred to a statement made by the General Financial Directorate's press secretary, that the financial administration awarded target bonuses to employees who assess additional tax in the area of research and development allowances and transfer pricing.

On 19 February 2016, the General Financial Directorate issued its Conditions for Awarding a Target Bonus. This document states that selected financial administration employees are to receive a target bonus, if, in tax proceedings initiated between 29 February 2016 and 31 December 2018 (or initiated before this date but not completed by 29 February 2016) they reduce the research and development allowances claimed by taxpayers by at least CZK 2.5 million.

In the case in question, the SAC concluded that the tax officers were not biased, as the major part of the tax inspection, including a hearing on the findings, had taken place before the mentioned document was issued. Furthermore, the SAC agreed with the tax administrator that the taxpayer failed to meet the formal conditions for claiming the research and development allowance, namely failed to support the date of the project's approval.

Notably, the judgement refers to the objective of the tax administration: to correctly ascertain and assess tax and ensure its payment. Tax administrator's officers should proceed within their powers and jurisdiction. Their motivation should not be distorted by unacceptable remuneration criteria based on the idea that the more tax you collect, the more you earn. According to the SAC, the unacceptability of the regulation is further enhanced by setting a minimum amount by which the allowance was to be reduced.

Case law

Operation of ATMs not VAT exempt

In the Cardpoint (C-42/18) case, the Court of Justice of the EU (CJEU) held that services comprised of the operation and maintenance of ATMs, including their replenishment and software and hardware installation, are not ‘transactions concerning payments’ and therefore not VAT exempt.

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Cardpoint GmbH, a German entity, filed a corrective VAT return for 2005, requesting the existing tax assessment be amended on the grounds that they had declared services they provided with output VAT, while later identifying them as VAT exempt. The company was in charge of the operation and maintenance of ATMs, as a part of which they installed hardware and software in the ATMs. They also arranged the transportation of banknotes provided by the bank and placed them in the ATMs. The German tax administrator rejected the request, stating that the above activities were not transactions concerning payments and therefore not VAT exempt.

The company appealed the decision, and the case proceeded to the CJEU. The prejudicial question was whether the technical and administrative supplies provided by Cardpoint were VAT exempt.

Cardpoint itself neither debited the bank accounts (only physically delivered the cash to selected ATMs), nor authorised transactions. The CJEU thus concluded that the services provided by Cardpoint neither had the effect of transferring funds nor entailed legal or financial changes characteristic of transactions concerning payments. Furthermore, the court concluded that the purpose of the provision laying down the exemption for transactions concerning payments was namely to alleviate any possible difficulties connected with determining the consideration for the supplies, therefore the tax base. In the Cardpoint case, however, the consideration could easily be determined as the company generated a non-editable list of all transactions for the day at the end of each day.

For services to be viewed as transactions concerning payments, they must, viewed broadly, form a distinct whole, fulfilling in effect the specific, essential functions of a payment, i.e. transferring funds or giving rise to changes in the legal and financial situation.

CJEU: German withholding tax on dividends paid to pension funds contrary to EU law

The Court of Justice of the EU (CJEU) issued a ground-breaking judgment concerning German withholding tax on dividends paid to foreign pension funds. According to the court, the withholding tax restricts the free movement of capital and is therefore incompatible with EU law. For entities worldwide, the door is now open to refunds of withholding tax paid in EU countries.

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The case in question involved College Pension Plan of British Columbia, a Canadian pension fund that received dividends from German joint-stock companies in 2007 to 2010. Under the Canadian-German double taxation treaty, the dividend was subject to a 15% withholding tax. The fund requested a refund of the withholding tax, arguing that it was discriminatory when compared to taxation of German (resident) funds. While the withholding tax rate for resident funds is higher (25%), because of the calculation mechanism (the possibility to deduct technical provisions for future pension liabilities and to offset the tax against the final tax with a possibility of refund of any excess tax paid), the taxation of resident funds was in fact significantly lower.

With respect to German resident pension funds, the court pointed out that the German legal regulation leads to a complete or at least partial tax exemption of dividends. Non-resident funds do not have such an option, and the withholding tax is final for them. The court concluded that a non-resident pension fund which uses the dividends received for pensions, whether voluntarily or as a result of regulatory requirements, is in a situation comparable to a German pension fund. However, it is for the referring court to assess whether this is the case in the situation at hand.

The court concluded that a less favourable treatment of non-resident pension funds constituted a restriction of the free movement of capital. The restriction cannot be justified by overriding reasons in the public interest, such as the necessity and effectiveness of fiscal supervision. The Standstill Clause does not apply here either; this clause allows restrictions of the free movement of capital between member states and third countries existing on 31 December 1993 and includes direct investments such as investments in real estate, establishment, the provision of financial services or the admission of securities to capital markets. The court thus concluded that this aspect of German legislation is contrary to EU law.

The CJEU judgement opens the door for pension funds to request refunds of tax unlawfully withheld in member states. The free movement of capital applies not only to entities from member states, but also to those from third countries. The practical implication of the judgement thus goes beyond the borders of the European Union.

Latest news, December 2019

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

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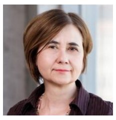

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DOMESTIC NEWS IN BRIEF

- At a regular meeting of the Economic and Financial Affairs Council (ECOFIN), the Czech Republic’s request to introduce a general VAT reverse charge mechanism was finally approved after five long years. The regime should apply to all transactions exceeding EUR 15 500 (CZK 450 000). Since this measure must be implemented into the VAT Act, it is yet unclear when and how it will enter into effect.

- An amendment to tax legislation for 2020 aiming to boost public budget revenues passed through the third reading in the deputies’ chamber and is headed to the senate. The proposed amendment will bring significant changes to the methods of creating technical provisions by insurance companies in compliance with Solvency II. The amendment also increases selected excite duties and tax rates on gambling and brings changes in the real estate tax area.

- An amendment to the government decree on material support provided to create new jobs and to requalify and train employees within investment incentives has been in effect since 1 December 2019. It introduces two main changes: material support for technological centres will be provided across the CR (except Prague) but for manufacturing only in regions with an unemployment rate of at least 7.5%.

- The long-planned e-sick note project will finally be launched on 1 January 2020, significantly changing the method of issuing temporary incapacity to work notes as well as the method of how employers will learn about their employees’ temporary incapacity to work. This information will be available either on the Czech Social Security Administration’s e-portal, or employers will have to ask for the automatic delivery of such information into their data boxes or via email. Nevertheless, employees will still have to inform their employers about their temporary incapacity to work without any undue delay (e.g. by phone or email). According to the new rules, after fourteen days of an employee’s incapacity to work, employers will have to electronically deliver to the CSSA an appendix to the application for sickness allowance stating the account to which the employee’s wages are transferred and, once the temporary incapacity to work terminates, all information necessary for the payment of the last sickness allowance.

- The rates of foreign *per diem* meal allowances for 2020 were announced via Decree No. 310/2019 Coll. as follows: EUR 45 for Germany, Austria and France; EUR 40 for Poland; and EUR 35 for Slovakia.

- The minimum wage should increase by CZK 1 250 to CZK 14 600 from January. A draft decree is yet to be approved by the government.

- The maximum annual assessment base for social security insurance for 2020 will increase to CZK 1 672 080.

- In 2020, reduction limits for sickness insurance purposes will increase as follows: the first reduction limit to CZK 1 162, the second to CZK 1 742 and the third to CZK 3 484.

- A government bill on the avoidance of double taxation with Taiwan was passed in the third reading and is headed to the Senate.
- A draft amendment to the Tax Procedure Code passed through the first reading in the Chamber of Deputies in early November.
- The number of trust funds has almost doubled over the last year, with less than one thousand in 2018 and 2 080 of trust funds at the end of November of this year.
- The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) was passed by parliament. Once signed by the president, it will be promulgated in the Collection of International Treaties and deposited with the OECD. For the CR, the MLI is expected to enter into force in April 2020, to be effective from 2021.
- A new double taxation treaty with Korea is likely to be effective from the beginning of 2020, pending only the exchange of ratification documents between the two states.

FOREIGN NEWS IN BRIEF

- The European Commission lodged an appeal against the judgement of the General Court of the European Union regarding the Hungarian advertising tax (Commission v Hungary Case T-20/17). The General Court in its judgement delivered in June rejected a European Commission finding that a Hungarian advertising tax was incompatible with EU state aid rules.
- The European Council acceded to a request for the extension of the period under Article 50.3 TFEU, under which the United Kingdom has signified its intention to leave the EU. The extension will apply until 31 January 2020 but includes flexibility for the UK to exit the EU at an earlier date if the Withdrawal Agreement negotiated between the UK and the EU is ratified by both parties in the intervening period. Until such a time, the UK will remain an EU member state with all corresponding rights and obligations of membership in effect.
- The OECD published other interpretation guidelines regarding the fulfilment and application of country-by-country reporting requirements (CbCR), as implemented within BEPS 13.
- Bosnia and Herzegovina signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) as the 90th jurisdiction of the signatories. Latvia and Mauritius have deposited their instruments of ratification for the MLI; the MLI will enter into force for both Latvia and Mauritius on 1 February 2020. An MLI ratification bill was submitted to the Estonian parliament; the MLI will enter into force for Estonia three months after Estonia lodges its instrument of ratification with the OECD. On 1 November 2019, the MLI entered into force for Norway.
- The upper house of the Austrian parliament approved a draft bill which introduces a tax on digital revenues derived from online advertising and imposes reporting obligations on operators of online platforms. The upper house also approved a bill to introduce anti-hybrid mismatch legislation into local Austrian law. The measures will enter into force on 1 January 2020.
- The German Federal Cabinet approved draft legislation to transpose EU Directive 2018/822 on mandatory disclosure rules (DAC 6) into German national law. French Ordinance No. 2019-1068 (the Ordinance) regarding the transposition of EU Directive 2018/822 on mandatory disclosure rules (DAC 6) into national law was published.

- The European Parliament adopted a resolution urging member states to agree on a position on proposals requiring public country-by-country reporting (CbCR) of taxes paid by multinationals. So far, EU ministers have failed to agree on the proposal first put forward in 2016. The proposal may be revisited again later in 2019 under the Finnish presidency of the European Council.

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