Tax&Legal Highlights

Czech Republic

Implementation of VAT quick fixes and generalized reverse charge mechanism has been delayed

Changes to the Czech VAT rules to implement certain "quick fixes" agreed upon at the EU level and to introduce a temporary generalized reverse charge mechanism, which were proposed to be effective as from 1 January 2020, have been delayed. It is uncertain when the changes will be officially enacted.

Quick fixes

As from 1 January 2020, the Czech Republic was required to amend its domestic law to introduce new measures provided for in Council Directive (EU) 2018/1910 regarding the existing functioning of the VAT system (i.e. the quick fixes). The measures are intended to have an impact on the application of the VAT exemption with respect to the sale of goods to another EU member state; to change the established method of the allocation of transportation in intracommunity supplies of goods in chain transactions; and to harmonize the rules regarding the taxation of sales via consignment warehouses using the call-off stock simplification.

However, the relevant amendments to the Czech VAT Act are still in the legislative process, and are unlikely to be enacted before April 2020. Until then, VAT payers either may follow the current wording of the VAT Act or they may rely on the direct effect of the EU directive and follow the new rules.

Temporary generalized reverse charge mechanism

Implementation also is delayed with respect to the generalized reverse charge mechanism for domestic business-to-business supplies exceeding EUR 17,500. The Czech Republic received an authorization from the EU Council on 14 November 2019 to derogate from article 193 of the EU VAT directive and to apply the mechanism from 1 January 2020 through 30 June 2022, to combat VAT fraud.

However, according to the Ministry of Finance, before implementing the generalized reverse charge mechanism, it is first necessary to prepare and approve another amendment to the VAT Act and to negotiate an extension of the derogation with the other EU member states for additional years. Therefore, the introduction of the new generalized reverse charge mechanism is unlikely to occur in the near future.

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New Double Taxation Treaty with South Korea and Other Changes in the Area of Double Taxation Agreements

On 20 December 2019, a new Double Taxation Treaty with South Korea became effective. The new agreement applies to income arising in the period commencing after 1 January 2020, or income paid on 1 January 2020 and later, if the income is subject to withholding tax. The new treaty changes the amount of taxation related to withholding tax on dividends and interest and provides also for other areas.

Selected parameters of the new treaty:

• The treaty sets a 5% withholding tax on dividends and interest.

• The treaty sets a 10 % tax on industrial licence fees and 0 % tax on cultural licence fees.

• Extension of the period for the origination of a permanent establishment in the form of a construction site to 12 months, addition of the concept referred to as service permanent establishment (for services provided for a period longer than 9 months within a 12- month-period.

• Gains from alienation of assets – addition of a clause referred to as "property clause" for transfers of securities or ownership interests, based on which the source state is allowed to tax gains from the sale of securities or ownership interests if more than 50 % of the company's assets comprise real property located in the territory of the given state.

Other Double Taxation Treaties

We would also like to point out that a double taxation treaty with Turkmenistan became effective on 1 January 2019. There was also a change in the interest rate in the double taxation treaty with Chile, with the rate being reduced from the original 15 % to 10 % (based on the activation of "the most favoured nation clause").

In 2019, a double taxation treaty was concluded with Bangladesh, Botswana and Kyrgyzstan, however, none of these treaties have been ratified yet.

On 27 November 2019, an act on the double taxation treaty with Taiwan was approved by the Chamber of Deputies, however, the legislative process has not been completed yet.

Changes in the List of Non-Cooperative Jurisdictions

On 10 October 2019, the European Council announced that it had removed the Marshall Islands and the United Arab Emirates from Appendix I of the list of non-cooperative jurisdictions for tax purposes (the "black list"). Simultaneously, the following countries were removed from Appendix II (the "grey list"): Albania, Costa Rica, Mauritius, Serbia and Switzerland. Nine non-cooperative jurisdictions remain on the black list: American Samoa, Belize, Fiji, Guam, Oman, Samoa, Trinidad and Tobago, American Virgin Islands and Vanuatu.

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Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) – Current Status in the Czech Republic

MLI is an international convention modifying a substantial portion of tax treaties and may result in the establishment of a new tax obligations. In the Czech Republic, the ratification process has yet to be completed; however, no revolution in the interpretation of tax treaties is expected as a result of the adoption of so called minimum standards. In other countries, the situation may be different. For example, Slovakia has already ratified the MLI and since 1 January 2020, the instrument has been applied to tax treaties with states where the ratification process has also been completed.

As we have already informed you in previous months, the Czech Republic joined the MLI in 2017 in Paris. However, as part of the convention, the Czech Republic selected to apply minimum standards, i.e. the mildest alternative. The Czech Republic has reserved the right not to apply most of the articles that should amend relevant provisions relating to the affected tax treaties. Moreover, the MLI application depends on the principle purpose

test (PPT), which is one of the minimum standards guiding determination of whether a transaction or an organisational structure had a principle purpose other than tax (such as economic). The test corresponds to the institutes of abuse of law (GAAR/general anti-avoidance rules) as adopted through the amendment to the Tax Code as part of the tax package for 2019, or 2020 if the taxation period corresponds to the calendar year. The minimum standard also includes rules for more effective dispute resolution.

By the end of 2019, the MLI has not been ratified, which means that in 2020, it will have no practical impacts on the existing tax treaties that are binding for the Czech Republic.

It should be taken into consideration that the level of accession to the MLI is not identical in all states and as such, it may have a more significant practical impact on the interpretation of treaties and tax administration in other countries. In some cases, the MLI will substantially change the wording of bilateral tax treaties. In many states, the MLI is already effective (e.g. in Slovakia, Poland, Austria, France, Netherlands, Switzerland, Luxembourg and other countries; for an updated list, please refer to the OECD website). We thus recommend verifying possible impacts of the MLI on the wording of treaties concluded with these states if your responsibilities include countries other than the Czech Republic.

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The Supreme Administrative Court's view of beneficial ownership in sublicense

At the end of last year, the Supreme Administrative Court (SAC) handed down a judgment on the application of withholding tax to income paid between two Czech tax residents on the basis of the terms of the concluded sub-licensing agreement. In its ruling (10 Afs 140/2018 – 32), the SAC found that the Czech company receiving royalties had been in fact a 'pass-through' element only and the beneficial owner of the royalties was a Russian company (tax non-resident). This non-resident company licensed a Czech company, which further ensured production under a sub-licensing agreement in another Czech company (applicant/complainant).

The Regional Court in České Budějovice and subsequently the SAC concluded that the Czech entity **had only been the recipient of the royalties, but not their beneficial owner**, since it had been obliged to pay fees to the Russian company as a licensor (with which it had a licence agreement concluded) in the same amount as the applicant itself paid to it under a sub-licensing agreement. According to the court, section 19(1) of the Income Tax Act is not fulfilled which defines the beneficial owner as the person receiving payments for his own benefit and not as an intermediary, representative or agent for another person. This should have been obvious to the applicant from the context and it should have therefore withheld and levied the tax at a 10% WHT rate from those fees (pursuant to Article 12(2)

of the Double Taxation Treaty between the Czech Republic and the Russian Federation).

The SAC sees no reason to distinguish between the taxation of regular recurring payments, the amount of which is based on the value of production, and the taxation of the so-called one-off (first) payment for granting a licence. The subject of the tax under the Czech Income Tax Act is compensations for the provision of the right to use other economically usable knowledge (know-how) whereby the one-off payment to the licensor (sub-licence) referred to by the complainant as a fee for the conclusion of a licence agreement falls in this category.

Liability is on the tax payer's side

The SAC's decision is relatively short, it does not give the details of the contracts and mutual relationships or what role any reorganisation of the beneficiary of (sub) royalties has played in the case. Basically, the cassation complaint merely copies the original action, which has previously been dismissed by the Regional Court, without the applicant coping in any way with its arguments. The SAC thus concluded that **according to Czech legislation, the Czech company as a payer of income was responsible for the withholding and payment of the tax in the proper amount** and since the applicant was aware that the beneficial owner of the royalties was ultimately a non-resident company from Russia and not the Czech company, it was to withhold and pay the withholding tax in accordance with the relevant Double Taxation Treaty.

In practice, the majority of payers verify this when paying income abroad, but in the context of the relevant judgement, **domestic payments need to be viewed from this perspective - in particular where there are indications or doubts as to whether the beneficiary of the income is their beneficial owner**.

We remind you that in the spring of the last year, the European Court of Justice issued interesting rulings concerning the requirement of beneficial ownership in relation to the application of the withholding tax exemption on the basis of European directives. (More in the article Interpretation of beneficial ownership by the EU Court of Justice) However, it did not decide regarding the concept of beneficial ownership as such, but rather abuse of law. This subject is quite topical even in the surrounding countries. We therefore recommend that you examine the tax aspects of the income paid and set up pertinent measures so that your company is not exposed as a payer to the risk of additional tax assessment.

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News in the Tax Area Effective since January

In December 2019, the President of the Czech Republic signed Press No. 509 of the Chamber of Deputies, which amends certain acts in the tax area, and thus finished the legislative process. The Act was published on 31 December 2019 in the Collection of Laws of the Czech Republic under No. 364/2019 Coll. This means certain regulations have changed since 1 January.

- **Act No. 586/1992 Coll., on Income Taxes, as amended (hereinafter the "Income Taxes Act");**
- **Act No. 593/1992 Coll., on Reserves for Establishing Income Tax Base, as amended (hereinafter the "Reserves Act");**
- **Act No. 353/2003 Coll., on Consumption Tax, as amended (hereinafter the "Consumption Tax Act");**
- **Act No. 187/2016 Coll., on Gambling Tax, as amended (hereinafter the "Gambling Tax Act").**

Income Taxes Act

We have already informed you of the planned changes in our previous article, **Planned Income Tax Changes for 2020**. Let us briefly summarise the following areas:

- ***Change in the taxation of interest income from bonds issued prior to 1 January 2013***

The amendment has annulled the exception (transitional provision) for bonds issued before 1 January 2013, meaning that all interest income is only rounded off at the level of total income tax from one issuer, regardless of the date of issue of the bond. The identical rounding-off method is thus used for all bonds, eliminating the advantageous position of the so-called "one-crown bonds".

The new rules apply to interest income that is realized by a taxpayer after 1 January 2020 from bonds issued prior to 1 January 2013.

- ***Change in the method of creation and tax deductibility of technical reserves in the insurance industry***

Insurance and reinsurance companies consider the creation of reserves under the Insurance Industry Act, which is based on the Solvency II directive, tax-deductible expenses. This, however, no longer applies to technical reserves created in line with accounting legislation. Technical reserves created based on accounting regulations will therefore no longer be considered a tax-deductible expense. The wording of the Act on Reserves has also been modified in this respect. Due to the fact that technical reserves created in line with the insurance act are not accounted for, reserves in the insurance industry will be reflected in the tax base in the form of non-accounting adjustments to the profit or loss.

It is estimated that the transition to the new system will have a relatively large impact on the tax liability of insurance and reinsurance companies. This is why the Act includes certain transitional provisions which should divide this tax burden into two taxation periods.

- ***Limitation to the tax exemption of the gambling winnings of individuals***

Gambling games have been classified into individual income categories. Winnings from lotteries, raffles and receipt lottery are now subject to withholding tax, under which the gross value of the winning (not reduced by expenses) is used as the tax base. The tax exemption only applies to individual winnings that do not exceed CZK 1 million. Taxpayers now have the possibility of including their income from lotteries or raffles, which was subject to withholding tax, in their personal income tax returns, where they can declare the withheld tax similarly as an advance payment if this is advantageous for the taxpayer. The withholding tax applies to winnings from lotteries and raffles obtained by individuals with effect from 1 January 2020.

Income from other types of games is subject to the same tax as other income in personal income tax returns, ie it will not be subject to withholding tax imposed by the organiser of the game (the payer). The tax base is calculated as the difference between the sum of the winnings of the given type of income (the given income category) and the sum of the stakes (deposits) in the game within the given type of income. If the difference between the total income and the total deposits from the respective gambling game (the given income category) does not exceed CZK 1 million for the entire taxation period, the income from the respective gambling games will be exempt from tax. No other expenses than the deposits (stakes) placed into the game, will be deductible from the tax base in the calculation. The new rules will apply to winnings from other types of gambling games that are subject to tax with effect from 1 January 2020.

Consumption Tax Act

We have already dealt with the changes proposed to the Consumption Tax Act in the **tax package article**, among other things. Let us briefly go over the key changes that the amendment introduces.

A major change concerns a significant increase in alcohol tax. Starting from 1 January 2020, the alcohol tax on products containing alcohol listed under nomenclature code 2207 (eg products with an alcohol content of over 80% or products containing alcohol which are used as fuel) and under nomenclature code 2208 (such as whisky, vodka, gin), and in other cases, is at CZK 32,250/hectolitre of ethanol. The tax has also been increased for alcohol contained in fruit spirits originating from minor distilleries (not exceeding 30 litres of ethanol per producer in the course of one production period), where the alcohol tax has been raised to CZK 16,200/hectolitre of ethanol.

Tax from tobacco products has also seen a major increase: the percentage for cigarettes has grown to 30%. The fixed tax rate is now at CZK 1.61/piece on cigarettes, CZK 1.88/piece on cigars and cigarillos, and CZK 2,460/kg on tobacco for smoking. The minimal tax rate on cigarettes has also been increased to a total minimum fee of CZK 2.9/piece. Tax has also gone up on heated tobacco products, where the tax rate is now CZK 2.46/piece.

As a result of the fact that this act has been passed, tax warehouse operators or beneficiaries entitled to repeated receiving of selected products

may now be obliged to change their "tax collateralisation". It is therefore necessary to calculate with this possible increase in the tax collateralisation.

Another interesting piece of news is the raised limit for home beer production (produced by natural persons). If the amount of beer produced in this manner does not exceed 2,000 litres per calendar year and is not sold, the producer is now not considered a taxpayer.

Gambling Tax Act

The tax package also includes a tax rate change concerning the partial tax base from lotteries, which should now be 35% instead of 23%. The original wording of the Amendment counted on an increase in gambling tax for the other partial tax bases as well, however the bill underwent several motions to amend, which led to the cancellation of the remaining tax increases from the final wording of the Act.

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Social Security Insurance Contributions and Changes from 1 January 2020 Onwards

Higher minimum salary, higher average salary and therefore higher maximum assessment base for the payment of insurance. These are just some of the changes brought by 2020. What other adjustments should we expect?

- **The maximal assessment base is CZK 1,672,080**
- **Average salary in 2020 amounts to CZK 34,835**
- **Minimum salary for 2020 has increased to CZK 14,600**
- **Decisive income for an employee's participation in sickness insurance is CZK 3,000, in respect of contracts for work, the limit is recognised income in excess of CZK 10,000**

Changes in prepayments for self-employed individuals:

- Minimum pension insurance prepayment is CZK 2,544;
- Minimum health insurance prepayment amounts to CZK 2,352;
- Minimum sickness insurance prepayment (voluntary) is CZK 126.

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