Tax&Legal Highlights

Czech Republic

R&D Tax Deduction
Regional Court: Clinical Trials of Medicaments Classified as Research

We would like to provide additional information on legal disputes concerning R&D deductible items, this time in the area of clinical studies. In late February, the Regional Court in Hradec Králové issued new judgments cancelling the ruling of the Appellate Financial Directorate (the "AFD"). Below is a summary of the key findings.

The Company won two legal disputes with the AFD pursuant to judgments 31 Af 53/2016 - 52 and 31 Af 52/2016 – 60. The Company sought the cancellation of the ruling whereby the AFD rejected the Company's appeal against additional corporate income tax payment assessments for the taxation periods of 2011, 2012, 2013 and 2014 whereby the assessments were confirmed. The subject matter of the dispute included the AFD's ruling stating that the Company did not carry out research and development in line with Section 34 (4) of the Income Taxes Act.

The Company is a registered medical facility conducting clinical studies predominantly of phase III, ie systematic testing of medicaments on patients to demonstrate and verify the healing powers of the medicament and identify side effects. This includes the testing of already-developed medicaments

following the completion of clinical testing phases I and II, according to the assignments of the Company's clients.

The AFD concluded that the Company had been engaged in an activity classified as the provision of services to a third party without own research as it only recorded the results of individual patients included in the project in relation to the administered medicaments. Moreover, the AFD believes that the administered medicaments did not represent an outcome of the Company's research and development activities and, as a result, this service did not include the element of own research. The AFD thus concluded that the Company's activities in the respective projects did not include an appreciable element of novelty and the Company was not exposed to the risk and uncertainty arising from research and development.

Nevertheless, the Regional Court did not agree with this conclusion and confirmed the Company's opinion that the activity in an R&D project consisted of seeking new findings regarding the effectiveness of medication and was performed by qualified professionals, which brought new findings on the healing powers of the respective medicament. What is more, the Regional Court also agreed with the Company's opinion that as such, the Company's performance of medical research entails the risk of failure of such research. This risk lies in the fact that it may come out during the clinical study that the testing practitioner incorrectly assessed the effects of administered medicaments and, as a consequence, failed to identify the danger for human health.

Therefore, the Company is not engaged in a mere routine activity solely including the record-taking of the results. The Regional Court believes that the Company's activities met the definition of research and development.

The Regional Court observed an unlawful assessment of the matter by the AFD in terms of substantive law and returned the case for further proceedings. The AFD subsequently filed a cassation complaint against the judgment at the Supreme Administrative Court. **This judgment is one of the few judgments at the level of regional courts which agreed with the taxable entity, observing that the definition of R&D activities and costs reported in a tax return was met.**

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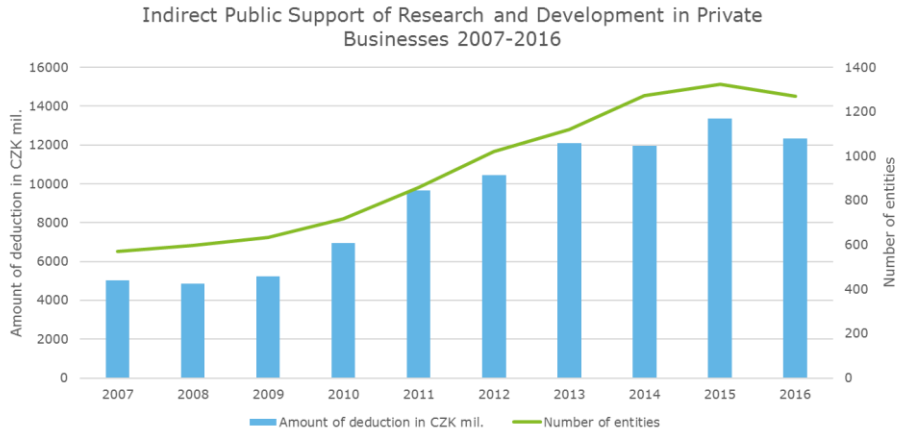
Current Trends in the Area of Deduction

As we have informed you in previous articles, R&D tax deductions are increasingly more often examined by the tax administration. The growing number of audits, which often result in legal disputes, leads to uncertainty among taxpayers. It is therefore questionable whether the setup of the deduction aimed at supporting research and development is the only accurate solution and whether it is time to consider an adjustment thereto, also considering the fact that the area has not been modified since 2005.

A decrease in the number of entities using the R&D tax deduction between 2015 and 2016 as well as a decrease in the aggregate costs reported by businesses as part of the R&D tax deduction in the same period proves the growing uncertainty among companies engaged in research and development in the Czech Republic arising from the tax administration's approach to the audit of tax deductions. This is alarming especially due to the fact that the decrease was recorded for the first time since 2005 when the R&D tax deduction was incorporated into legislation and also with regard to the boom in the Czech economy at present.

The figure below clearly depicts the statistics of applying the R&D tax deduction using the data of the Czech Statistical Office.



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Amount of deduction in CZK mil.	5 017	4 857	5 246	6 931	9 665	10 435	12 090	11 954	13 351	12 337
Number of entities	570	596	632	716	859	1 021	1 120	1 271	1 322	1 268

Source: Czech Statistical Office

We consider it problematic that formal project elements are currently preferred to the fact whether the company conducts research and development. Rather contradictory statutory requirements placed upon the research and development project documentation pose another issue. This includes, on one hand, the definition and approval of research and development activities prior to their commencement when the taxpayer does not (and cannot) have detailed solution descriptions as well as a sufficiently

accurate and detailed definition of activities, including their timing, budget, staffing etc, on the other hand.

The current setting and practice bring about a great deal of uncertainty and disputes regarding the project commencement, factual definition of project activities and the onset or clarification of research and technical uncertainty.

Inspiration for potential changes in the setup of R&D deduction may be found abroad. In many countries having the R&D deduction in place, R&D projects are only processed retrospectively, subsequent to the termination of the respective taxation period and the relevant development task. This change could resolve persistent disputes between businesses and the tax administration concerning the definition of the term "project solution commencement". Furthermore, it could enable tax payers to specify in greater detail how exactly project activities were realised in the respective period which could ultimately be beneficial for the tax administration in assessing eligible activities.

The latest information indicates that the financial administration is considering certain changes in the setup of R&D deductions. Let us hope that these changes will support research and development in the Czech Republic, contribute to the more-transparent assessment of R&D activities and direct attention to the actual substance of the issue rather than to the fact whether or not companies are really engaged in research and development. Greater transparency in R&D deduction is important for both companies operating in the Czech Republic and businesses considering the establishment of new or expanding existing R&D centres in the CE region and contemplating in which CE country the centre should be located. The transparency of individual support regimes in the relevant countries is one of the key factors in this decision-making process which is crucial for whether or not the Czech Republic will be selected.

In view of the Czech Republic's efforts to support primarily investments with high added value, it should be essential for all of us that the R&D deduction setup become more transparent for businesses.

We will keep you updated on further developments in future dReport issues.

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New treaty with Turkmenistan

Implementation of the new Double Taxation Treaty with Turkmenistan will start on 1 January 2019

On 27 March 2018, the Double Taxation Treaty between the Czech Republic and Turkmenistan came into force. The wording of the Treaty is expected to be published in the Collection of International Treaties shortly. The provisions of the Treaty should be applied as follows:

- In respect of income and property taxes, the Treaty will be applied to income paid or credited as of 1 January 2019 or later.

- In respect of withholding tax, the Treaty will be applied to income paid or credited as of 1 January 2019 or later.

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Courts Have Once Again Sided with Entrepreneurs in Respect of Payment Security Orders

The Supreme Administrative Court has again confirmed that it makes sense to defend yourself against the practices of the financial administration. In its latest ruling on the AB Chemitrans case, the court ruled that tax or related accrued interest and fees can only be recovered by distraint after the appellate proceedings have been concluded, which also applies to situations where the tax was subject to a payment security order. The ruling may significantly affect the existing practices relating to payment security orders and the performance of tax distraints.

In general, it applies that if the tax authority makes an additional tax assessment based on a tax audit, the additionally assessed tax is payable within 15 days of the delivery of the ruling on the appeal. Therefore, the tax authority is not allowed to collect the tax until after the appellate proceedings have ended when the payment assessment comes into force. However, if the tax is secured by a payment security order in advance, the tax authority has so far believed that the additional payment assessment may constitute grounds for a tax distraint as early as on the date it is delivered, ie regardless of the appeal filed. At that moment, the payment security order ceases to be effective, with the tax authority proceeding to perform the distraint and recovering the tax payable based on a payment assessment. However, in its latest ruling on the case of the Moravian company AB Chemitrans, the Supreme Administrative Court ruled that additionally assessment tax may

only be recovered by distraint until after the appellate proceedings have ended with legal effect, which also applies to situations where a payment security order has been issued in the case in hand.

The legal opinion may have several practical implications. First, it may be inferred that payment security orders do not cease to be effective until after the appellate proceedings have ended with legal effect. Therefore, if, in the meantime, the appellate body or court revokes the payment security order for unlawfulness, the tax authority will be forced to refund the secured amount. The ruling may also affect the unlawfulness of the tax distraints already underway. In this regard, the issue of interest on unlawful acts, which the tax authority should pay to companies in situations like these, will also come into play.

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News in Immigration

Changes in the Ukraine Regime Project

The Ukraine regime was officially launched in August 2016. The Ukraine regime simplifies the hiring of employees from this country. It is intended for direct employers operating in the Czech Republic in the field of production, services or the public sector. Temporary help from Ukraine can help bridge the time when the Czech Republic's unemployment rate is critically low and companies currently lack 240,000 workers.

- Starting from 1 May 2018, the quotas will increase from 9,600 applications per year, i.e. 800 applications per month, to 19,600 applications per year, i.e. 1,600 applications per month (family members are not included in the quota).

- When filing a collective application for 50 or more people, it has been required since 1 February 2018 to demonstrate that the intention has been discussed with current employees and that approval of the mayor of the municipality where the foreigners will be accommodated after arriving in the Czech Republic has been obtained.

- As part of the increase in the number of accepted applications in the Ukraine regime, there is a concurrent increase in the capacities by the Ministry of Foreign Affairs at the Czech Consulate in Lviv.

- **Starting from 1 May 2018, applications for employee cards will be filed via the Lviv visa centre.** The visa centre will be created following the increase in the Ukraine regime quota. At present, a selection process for the external provider of the visa centre services

is being conducted. Applications filed via the visa centre will entail a new fee for application processing. The fee is not expected to exceed EUR 20.

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The Mongolia Regime and the Philippines Regime

Other special programmes are intended to provide companies with temporary help to overcome the period of lack of employees. The Mongolia and Philippines regimes has been introduced with effect from 1 May 2018. They focus on countries whose labour force has continuously been a centre of interest of Czech employers.

The regime as such should serve for targeted and selective acceptance and processing of applications for employee cards by citizens of Mongolia and the Philippines who will perform work activities in the Czech Republic in the area of production, services or the public sector (on job positions CZ ISCO 4-8).

- The targeted and selective nature means that similarly to the Ukraine regime, the other states regime can include only a specific employer that meets the regime's criteria, together with a specific future employee or employees.

- Decisions on the applications for inclusion in the regime will be made by the Ministry of Industry and Trade (MIT) based on a recommendation from the Czech business representation or the CzechInvest Investment and Business Development Agency. The annual capacity for this project is 1,000 applications from each of the above countries (i.e. approximately 85 applicants per month per each country).

- Employee card applications will be accepted by embassies in Ulaanbaatar and Manila. After the monthly capacity of the respective embassies is filled, application acceptance will be suspended. Unlike the Ukraine regime, applications for the other country regime will not be put in an endless line. The applicants will be able to register several weeks in advance.

- The regime is intended only for direct employers that have been active in the Czech Republic for at least two years in the area of production, services and the public sector, that employ at least 10

people, have no payables to the state and have been persistently unable to fill an available job position from Czech labour market resources. The job position where the applicant included in the regime by the employer would be employed must correspond to the employer's business activity.

The regime also allows filing a "collective application" for 30 or more applicants, with the employer having to complement the application with a sworn statement that it will cooperate with the Centres for the Support of the Integration of Foreigners in the region, a sworn statement about having discussed the intention with employees in line with Section 280 (1) of Act No. 262/2006 Coll., Labour Code, and a statement of the mayor of the municipality where the foreigners will be accommodated after arriving in the Czech Republic.

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Changes of conditions for filing an employee card application in Lviv

More than three quarters of Ukrainian employee card applicants are accepted via the government project. The Ministry of Foreign Affairs of the Czech Republic decided to end the so-called live queue and to introduce instead electronic registration via a dedicated e-mail address. All citizens can make a request for assigning a date in this way on their own and free of charge. One of the main reasons for this new setup was to eliminate intermediaries who abused the existing system. The registration does not take place via the Consulate General but via the Ministry of Foreign Affairs headquarters, so that the Consulate General cannot be accused of changing the order.

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Transposition of the EU directive

The reports on the transposition of Directive 2004/114/EC and Directive 2005/71/EC showed a variety of flaws and the need to perform several changes. For the sake of clarity, the EU decided to rework both directives and replace them with a new one.

For this reason, the European Parliament and the Council approved on 11 May 2016 Directive 2016/801/EU on the conditions of entry and residence of third-country nationals for the purposes of research, studies, training, voluntary service, pupil exchange schemes or educational projects and au pairing (hereinafter "Directive 2016/801/EU"). EU member states have until 23 May 2018 to enforce legal and administrative regulations necessary to achieve compliance with this Directive. The primary changes will concern particularly the provisions on long-term residence permits for study purposes and the definition of the term "studies". The main changes are summarised below.

- Introduction of long-term residence for the purposes of job seeking or initiation of business activity. This residence purpose will be intended for university students after the end of their studies in the country and for research workers who have completed their research activities. In these cases they will be allowed to remain in the territory of the Czech Republic for up to 9 months in order to look for employment or initiate business activity. However, this permit will not automatically mean the granting of the right to access the job market or to initiate business activity.

- Obligation to attend adaptation and integration courses. The efforts for the integration of foreigners residing in the territory of the Czech Republic in the long-term will no longer be on a voluntary basis only – the element of limited and corresponding obligation will be introduced: the conditions for residence in the country will include (in certain cases) the obligation to attend an introductory adaptation and integration course for new arrivals within one year of receiving their Czech residence permit. The amendment introduces this obligation due to the identified necessity to inform foreigners especially about their rights and obligations as soon after their arrival in the Czech Republic as possible.

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