Tax&Legal Highlights

Czech Republic

Demonstrating the Receipt of Intragroup Services: Are you Prepared?

A large number of Czech businesses that are part of multinational groups already have first-hand experience that the Czech tax administration's approach has undergone a fundamental change in recent years as regards tax audits focusing on related party transactions. The lack of any form of communication with the tax administrator (such as on-the-spot inspections) concerning related party transactions is rather an exception at present. Contrarily, regular contact with tax payers or directly a tax audit of intragroup transactions is becoming common practice.

With the information which is available to the Czech tax administration, either based on statutory reporting as part of income tax returns, information exchange with foreign tax administrations or disclosures made by the tax payer itself, the tax administrator already has a wealth of data and a clear objective prior to initiating the tax audit. Our advisory practice indicates that it is very often the audited taxable entity which is taken by surprise by the tax administrator's approach and requirements.

Tax administrators being cautious about "management services"
Among other things, tax offices pay increased attention to intragroup services

rendered by the parent or another group company which are referred to as (usually not entirely accurately) "management services". These may involve a broad variety of advisory and ancillary services, ranging from general administrative, financial and legal services to technical and more specialised ones. Such services are frequently ensured for most group entities in a centralised manner. Even though the provision of such services in multinational groups has economic substantiation, tax administrators are rather cautious and distrustful in respect of them in tax audits. An increasingly greater emphasis is given to the detailed demonstration of all relating facts. Tax administrators place demanding requirements on means of evidence, primarily as regards their convincingness, formal elements and authenticity. What was accepted by the tax administrator in the past is usually no longer sufficient at present.

In assessing the tax deductibility of expenses relating to intragroup services, it is usually initially demonstrated that the expenses were incurred by the tax payer in achieving, ensuring and retaining taxable income (Section 24 (1) of Act No. 586/1992 Coll., on Income Taxes). It is the taxable entity that must bear the burden of proof in this discovery stage. Only subsequently, when the evidence supplied by the taxable entity is successful, the transfer pricing of the respective transaction is tested. It is, however, no exception that in the event of the tax payer's failure to bear the burden of proof, the second stage will not take place.

Example: Legal dispute concerning the deductibility of expenses

As an example, a legal dispute has been recently closed which dealt with, *inter alia*, the deductibility of expenses for advisory services provided by the parent company and expenses for legal services provided by an external law office whereby 50% of those expenses was allocated to the taxable entity. The Supreme Administrative Court (the "SAC") rejected the taxable entity's cassation complaint (8 Afs 216/2017-75) and thus acknowledged the previous decision of the Regional Court in České Budějovice (10Af 5/2016-80) confirming an additional tax assessment exceeding CZK 14 million, which was assessed by the tax administrator using auxiliary tools, due to a failure to demonstrate the services received from a related party.

Although the taxable entity provided the tax administrator with a great deal of evidence including hundreds of various documents, the tax administrator rejected the presented means of evidence emphasising that the taxable entity only provided a general description of services, does not show the specific time spent, the actual cost of provided services or in which amount the respective service contributes to the aggregate value invoiced. The SAC agreed with the tax administrator's course of action and, similarly as the Regional Court, has not found any deficiencies in this respect.

Nevertheless, it may be more important for taxable entities in a similar situation as the tax payer in the above-specified legal dispute that neither the Regional Court nor the SAC give any indication in their decisions as to which means of evidence would be sufficient in such a case.

Thorough preparation a necessary prerequisite

Although tax payers may be considered to show uncertainty as to which document will or will not serve as sufficient evidence in a tax audit, the

situation is not entirely hopeless. It is highly advisable to prepare for the tax administrator's potential questions in advance. How?

- Collect regularly, already in providing services, all paper documents demonstrating facts relating to the services provided, starting from orders of particular services (including the relevant communication concerning the scope and costs of services and anticipated outputs);
- Collect all outcomes of the services provided (such as presentations, analyses, overviews, calculations etc);
- Collect all documents confirming the receipt of outcomes and the recipient's feedback as regards the services provided;
- Identify specific persons on the part of the provider who are rendering the services to the specific taxable entity, including, for example, as a list of tasks or an overview of the time spent with respect to the services in question;
- Collect all means of evidence demonstrating who prepared the outputs and individual documents and when; and
- Review or reset processes with regard to the circulation and archiving of documents.

It should also be noted that in the event of intragroup services, it is possible or advisable to draw inspiration from similar relations among independent entities. In such situations, business relations are not established automatically. Services without orders or agreements and a pre-arranged scope and cost would not be provided. In return for payment, recipients expect required, previously agreed outputs. This should also be the case of services rendered within a group. It is therefore necessary that the service provider (eg a parent or another service company) already cooperate with the taxable entity before and during the provision of services. Such cooperation is an essential prerequisite of success.

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The echoes of tax inspections on one-crown bonds

The discussion concerning one-crown bonds is continuing. As repeatedly debated in the media, the Financial Administration continues to carry out tax inspections of the companies which issued so-called one-crown bonds through the end of 2012. Proceeds from these bonds issued through the end of 2012 are not subject to effective taxation due to the rounding down to the whole Czech crown. Although at the time it was a routine form of financing, nowadays, the tax authorities in many cases challenge the economic reasons for placing one-crown bonds, treating the issuance of such securities as an abuse of law with all the related tax consequences.

The first ruling of the Supreme Administrative Court on one-crown bonds

In August 2018, the Supreme Administrative Court dealt with the tax inspection of the one-crown bonds for the first time. In this case, the complainant did not contest the amount of the additionally-assessed tax

liability but claimed the illegality of the tax inspection as such. The illegality of the tax inspection was inferred by the complainant based on the fact that it had not been initiated on the basis of a "free decision" of the Director-General of the General Financial Directorate, but on the basis of political pressure. According to the complainant, it was not the Financial Administration, but the Chamber of Deputies (especially its Budget Committee) that decided to examine the placements of the one-crown bonds made in 2012.

The Supreme Administrative Court did not concur with this conclusion on the illegality of tax inspections. The Court admitted that the question of one-crown bonds and related inspections was intensively publicly debated and individual political leaders also expressed their opinion. However, according to the court, it was not proved that the Financial Administration had acted directly on the order of the Chamber of Deputies or because of political pressure. On the contrary, the court noted that it is normal for the Financial Administration to initiate a tax inspection not only on the basis of its own activities but also on the basis of public inquiries and facts obtained from other state authorities (e.g. from the Police of the Czech Republic). The conceptual decisions on what issues the Financial Administration will focus in its inspection activity is fully within the remit of the Director-General of the General Financial Directorate.

Up to now, this ruling of the Supreme Administrative Court does not address the correctness of the conclusions of the tax authorities regarding one-crown bonds. Therefore, we will still have to wait for the answer of whether and in which cases the issuance of one-crown bonds can be considered an abuse of law.

Bonds may be subject to taxation in the future

In the context of the tax inspections on one-crown bonds, the Ministry of Finance is also coming back to the proposal to amend the Income Taxes Act, according to which proceeds arising from the one-crown bonds should be subject to taxation regardless of when the bonds were issued. According to the most recent information, this legislative amendment should become part of the governmental package, which will come into effect by 2020 at the earliest.

In early 2017, the government supported the proposal to amend the Income Taxes Act, but even then, it was clear that the then Chamber of Deputies would not be able to pass this amendment before the election. According to the governmental proposal, taxation was supposed to apply on the one-crown bonds purchased by natural persons from their own companies or otherwise linked to the issuers of one-crown bonds.

The proposal for the current legislative amendment is not available yet. However, preliminary information from the Ministry of Finance indicates that, in addition to the one-crown bonds, the taxation should also extend to other types of bonds.

It may be assumed that, in the context of the planned legislative amendments, the following question will arise: to what extent the proposed taxation can be retroactively applied to the already issued bonds. Retroactive application of tax regulations may run counter to basic legal principles and relevant investment protection treaties. Therefore, it is apparent that the debate regarding the one-crown bonds will be continuing. We will inform you about further developments in the practice of the Financial Administration and administrative courts. If you have any questions about tax inspections on bonds, we will be happy to answer them also in person.

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The Czech Ministry of the Interior has Issued Brexit-Related Recommendations to UK Citizens

In relation to the upcoming exit of the United Kingdom of Great Britain and Northern Ireland from the European Union in spring 2019, the Ministry of the Interior of the Czech Republic has issued recommendations addressed to the citizens of the United Kingdom residing in the Czech Republic.

The recommendation proposes a procedure to the UK citizens who are interested in preserving their rights related to their residence in the Czech Republic until the end of the transitional period (i.e. until the end of 2020) after Brexit.

In its call, the Czech Ministry of the Interior strongly recommends that all UK citizens who are not holders of *the Certificate of Temporary Residence of an EU National* apply for the issuance of the *Certificate* and thereby avoid any more complex administrative procedures in the future.

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The financial administration has easy access to information. "Big Brother" can see the income of natural persons too

The times when the financial authorities could discover "forgotten" income of taxpayers only during a specific tax audit are long gone. Thanks to digitalisation and the use of technologies in many areas of activities, the tax office can now find what it needs much more easily – or even receive the information automatically.

An example of an active approach of financial authorities is the case of additional taxation of income generated through Airbnb. Thanks to the data received from Airbnb, the financial administration can easily find out what income taxpayers should tax, and if they have not done so, it can ask them to remedy that. Uber also promises direct cooperation; for both electronic platforms, the tax office profits from the fact that the platforms **record all the information necessary for additional tax assessment**. We could continue in this way in many other areas, including e.g. the mediation of trade via Aukro and similar companies or portals facilitating paid car sharing.

However, sometimes all the financial administration has to do is wait and the information will come on its own: thanks to international initiatives such as FATCA (from the US), the Common Reporting Standard (adopted by the OECD) and the directive on administrative cooperation of the European Union, the financial administration suddenly **receives specific information about the income of natural persons**. Based on practical experience, it then asks employees who have forgotten e.g. about income from an option programme of their Czech employer's parent company to file a tax return and pay the tax owed, including a penalty for additional tax assessment and default interest for late payment.

It therefore becomes increasingly worthwhile not to forget about any kind of income arising from any source – if you are not sure about the correct way to tax your income, we recommend seeking advice from a tax advisor before the tax office contacts you.

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