Tax&Legal Highlights

Czech Republic

The Proposed Amendment to the ITA Brings Changes for Both Legal Entities and Individuals

The Ministry of Finance has released a proposed amendment to the Income Taxes Act (the "ITA") for consultation, through which the new anti-tax avoidance principles arising from the ATAD Directive (Council Directive EU 2016/1164 of 12 July 2017) should be implemented, including the abolition of the "super-gross salary" and the "solidarity tax surcharge", while, at the same time, increasing the personal income tax rate.

In addition to the changes for legal entities and individuals described below, all payers should be subject to the new anti-abuse rule (or general anti-abuse rule), currently only inferred by the judicature in certain cases. According to the amendment, the Tax Code should specifically provide for the procedure in situations where the main, or one of the main, aims of the transaction is to generate a tax or another benefit in breach of the letter and spirit of the law.

I) Changes for Legal Entities

The new taxation principles primarily affecting large companies with cross-border operations are based on the ATAD. The Directive stipulates **five anti-tax avoidance measures**: the interest limitation rule, exit taxation, general anti-abuse rule, controlled foreign company rules, and hybrid mismatches. The ATAD implementation deadline is 31 December 2018; therefore, the proposed amendment to the Income Taxes Act must become effective on 1 January 2019, at the latest (except for the exit taxation and hybrid mismatches rules, in respect of which the implementation period is extended until the end of 2019, or 2021 for 'reverse hybrid mismatches').

In summary, the amendment proposed with respect to ATAD implementation:

- **New additional rules for the tax deductibility of financial costs** which should newly be limited to 30% of adjusted EBITDA or by a threshold of CZK 80 thousand (approx. EUR 30 million);
- **Introduction of CFC rules** – additional taxation of selected income in case of subsidiaries based in states with a low taxation level at the level of a Czech parent company;
- **Introduction of exit taxation**, when a taxpayer moving his tax residence, business activities or assets from the Czech Republic would be taxed based on the market value of assets to be moved.

II) Changes for Individuals

With effect from 1 January 2019, the proposal should abolish the super-gross salary, or the inclusion of insurance premiums paid by the employer in the tax base of individuals' income from dependent activities. Employees' tax bases should newly only consist of their gross income. The proposal will additionally abolish the solidarity tax surcharge, which complicated the calculation of tax in respect of persons with higher income.

However, the tax rate will increase. Instead of the existing 15% rate, two rates will be introduced: 19% for income of up to CZK 1.5 million a year, and 24% for income in excess of the threshold.

Employees with lower income will, in effect, see a 1.1% decrease in taxation (19% as opposed to the existing 20.1% effective tax rate), with higher taxation applicable to persons with rental income and persons with other income (these were only subject to a 15% tax rate following the deduction of expenses).

Entrepreneurs and other entities with income from independent activities will be compensated for the increased tax rate by the possibility to deduct three quarters of the social security and health insurance contributions made on top of standard expenses (actual or flat-rate expense charge-offs). In theory, their taxation should remain substantially unchanged thanks to the deduction; however, tax calculation and related administration will become more complicated for them.

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A Change in the Treatment of Tax Exemption of Income from Royalty and Interest Payments?

In late January, an important ruling of the Supreme Administrative Court (SAC) was issued under Ref. No. 3 Afs 250/2016. The ruling is related to tax exemption of income from royalty payments and interest on a debt financing instrument.

The common system of taxation applicable to interest and royalty payments made between associated companies of different Member States has been introduced by the European Union by way of Council Directive 2003/49/EC (Directive). The Czech Republic implemented this system into its national tax legislation by way of the provision under Section 38 (nb) of Act 586/1992 Coll., on Income Taxes (ITA).

The subject of the assessed case was a negative ruling passed by the Tax Administrator in terms of acknowledging the tax exemption of income from interest on a debt financial instrument for 2011 and 2012 based on an application filed by the taxable entity in July 2013. According to the Tax Authority, and as later confirmed by the Appellate Financial Directorate, the application for tax exemption could not be approved due to the fact that it was filed too late. In terms of the late filing, the authorities stated that a critical precondition to utilise a tax exemption is to obtain a resolution of a constitutive nature. In other words, this means that tax exemptions may be utilised no sooner than after the issuance of the relevant tax exemption resolution, ie not backwards.

In its appeal, the taxable entity principally referred to the Directive as such, which stipulates that if the taxable entity's company withholds tax at source in a case in which tax exemption should be used, an **entitlement arises for the taxable entity to seek the refund of the tax withheld in this way, within a period of at least two years from the date on which the interest and royalty payments were made (if the tax exemption preconditions have been *de facto* met)**. Given that in the Czech Republic, tax exemptions depend on the issuance of a resolution under Section 38 (nb) of the ITA, the two-year period for refunding withheld taxes may be connected with the point at which the application for tax exemption was filed.

The SAC upheld this opinion of the taxable entity and stated that the importance of decisions on tax exemption lies in the authoritative confirmation of matters based on which the entitlement to tax exemption originates and the fulfilment of which is required in order to achieve the exemption of interest from withholding tax.

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A New Form of the TP Attachment to the Corporate Income Tax Return

Since 2014, taxable entities that meet specific criteria have been obliged to fill in an appendix to the corporate income tax return related to intercompany transactions. Also due to this measure, transfer prices have attracted the attention of the tax administration more significantly. The taxable entity is supposed to fill it in, if it meets at least one of the following criteria: the entity owns assets of at least CZK 40 million; the entity generates turnover exceeding CZK 80 million; the entity's average recalculated headcount equals 50 and, simultaneously, the entity performed a transaction with a related entity abroad, incurred a loss or was granted a promise for investment incentives and, simultaneously, performed a transaction with a related party. In short, these are the preconditions indicating that the taxable entity is obliged to inform the tax administration on its intercompany transactions in detail.
In 2018, the tax administration has issued a new form of the attachment that is to be filled in already for the 2017 reporting period. The attachment has been extended to include additional lines, specifically in Table B where, for the first time, the costs and income from rents will be filled in (Line 4), and in Table C, where the taxable entity will newly indicate whether it provided or received any financial or bank guarantees.

The obligation to file the transfer pricing attachment will newly apply to financial institutions. It is still valid that the attachment is not to be filled in by the permanent establishment of tax non-residents.

All details necessary for the preparation of the attachment to the tax return are described in the instructions provided for the filling of Item 12, Part I of the corporate income tax return.

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Upcoming Amendment to the VAT Act

The Czech Ministry of Finance has presented the first proposed amendment to the VAT Act, which should (barring exceptions) become effective on 1 January 2019. The amendment is set to fully revise the rules for correcting the tax base or the possibility of decreasing VAT in respect of irrecoverable receivables. It introduces special treatment for taxing vouchers for the purchase of goods/services, thereby transposing the relevant EU Directive. Additional transposition of EU rules includes the implementation of new processes for services provided electronically to non-taxable entities. The changes should also specifically affect the financial sector (a new definition of finance leases, application of exemptions to independent groups of entities) and the real estate industry (inclusion of certain work on the property in the compulsory/voluntary adjustment of tax deductions, impossibility of imposing tax on premises rented for housing purposes). Furthermore, the changes with general implications include a stricter approach to issuing tax documents and their delivery.

At present, comments on the amendment to the VAT Act made by experts as well as non-specialists are being processed. The Czech Ministry of Finance should subsequently address these and submit the amendment for the subsequent legislative process.

Supreme Administrative Court Ruling on the Rejection of a Tax Deduction Claim

In its recent ruling 5 Afs 60/2017, the Supreme Administrative Court addressed the possibility of rejecting a tax deduction claim made by a payer in a situation where the supplier declared the relevant tax, yet the subcontractor failed to pay VAT at the very beginning of the entire business chain. The ruling has been recently referred to by the media as ground-breaking as, in certain cases, it benefits the fact that the tax administrator is generally unable to reject the tax deduction at all if VAT was not paid by an indirect, rather than direct, business partner. This would, indeed, be a revolutionary assertion. Nevertheless, the Court has not stated any such thing: it merely rejected the tax administrator's assertions that the payer was demonstrably aware of the failure to pay tax, or should have and could have been aware of it. The other sub-comments made by the court in relation to individual "errors" on the part of the payer are quite apt, yet in no way innovative: they merely uncover the fact that the tax administrator's actions were entirely mistaken and rash and do not in any way advance the view on the issue of proving participation in tax fraud. Nevertheless, we **consider this ruling to be of great use and it will surely be a convenient means of protecting tax payers' rights**.

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The Czech Republic wants to amend the rules for posting employees in the EU

The EU Posting Workers Directive shall be amended, claims the Czech government. Currently, it complicates the life for many employers that post their employees abroad: the employers have to register at the authorities of the respective states, they have to provide the employees with numerous documents (e.g., A1 certificates, copies of employment contracts etc.). In addition, the rules for minimum wage and other labour law obligations need to be obeyed. The Directive is now subject to revision, as part of which the Czech government asks, among others, for excluding international transit. However, employers from other industries may expect the tightening of the rules, requested especially by West European countries. We will keep you informed about any updates.

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