Tax&Legal Highlights

Czech Republic

Upcoming Changes in the Income Taxes Act

What substantial changes may be expected this year?

As we already informed you in last year's issues of our bulletins, the Ministry of Finance is preparing a draft of a **completely new income taxes act**. The effectiveness of the new act is conditioned by a new IT system of the Financial Administration, the introduction of the institute of self-assessment and individualisations, ie distinguishing tax accounts up to individual natural persons-employees. Given the long term for the realisation of these projects, it is obvious that the act will not be completed in 2018, even though the Ministry of Finance may present some of its main ideas.

In the next few days, however, the Ministry of Finance is expected to put a **draft of a relatively substantial amendment to the current wording of the Income Taxes Act** to the comment procedure; this Amendment should, among other things, implement the so-called ATAD – EU directive laying down rules against tax avoidance practices. The period for the implementation of this directive is set for 31 December 2018. In the comment procedure, a relatively intensive discussion is expected, as the Amendment will bring quite significant changes for companies, those being mainly the following:

- New rules for the tax deductibility of interest and similar charges for all corporate income tax payers – tax deductibility of financial costs should newly be limited to a certain level of adjusted EBITDA (with 30% being mentioned) or by a threshold up to EUR 3 mil. (approx.. CZK 80 thousand);
- Introduction of controlled foreign company rules (so-called 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 so-called exit tax – 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.

This Amendment is likely to also comprise other changes in income taxation. We will inform you about the specific wording of the proposed changes once the Ministry of Finance has presented the material to the comment procedure.

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R&D Deduction – Further Requirements for Taxable Entities?

In late 2017, a new judgment of the Supreme Administrative Court (hereinafter the "SAC") was issued, raising further doubts among many taxpayers as to the accuracy of their current approach. Below is a brief summary of the principal points of the judgment.

TRANSYS, spol. s r.o. (hereinafter the "Company") lost a legal dispute with the Appellate Financial Directorate on the basis of the SAC's judgment 10 Afs 77/2017 - 53. The subject matter of the dispute related to decreasing the tax liabilities arising from the application of the R&D deductible item in the Company's additional tax returns and the subsequent challenging of the lawfulness of the R&D deduction by the tax administrator.

In its judgment, the SAC addressed a number of critical matters. The SAC opines that the Company did not have stand-alone expense records and failed to bear the burden of proof in contending that the Research and Development Project (hereinafter the "Project") as the critical document in applying the tax deduction had been signed before development activities commenced. In both cases, these requirements are explicitly required by the Income Taxes Act and, as indicated by the SAC's previous judgments, if the taxable entity fails to defend compliance with these conditions, the tax deduction is rejected in full. Among other things, the doubts concerning the late signing of the Project arose from the fact that the internal bookkeeping policy did not contain any information that R&D expenses would be accounted for by the Company, as well as that the Company applied the R&D deduction by means of additional tax returns.

Furthermore, the tax administrator contested a failure to comply with a number of the Project's formal requirements. According to the SAC, the Project was prepared at an overly general level, being only specified by means of particular sub-projects arising from particular engagements performed by the Company for specific customers; the SAC opines that these engagements were not mutually interconnected. The SAC agreed with the tax administrator in that the Project activities and objectives were too general and the setup of their assessment was insufficient. What is more, the Company failed to demonstrate that, in practice, evaluation reports were always issued subsequent to the completion of individual sub-projects as defined by the Project.

In this context, it should be noted that the Project is a prospective (i.e. planning) document which must be signed prior to the commencement of R&D activities. Neither the Income Taxes Act nor other legislative sources provide the required scope of specification of the planned activities, including the manner of their assessment. A taxpayer is therefore confronted with a difficult task: to draw up the Project before implementing any activity and, on the other hand, describe the Project with the sufficient level of detail. Taxpayers are thus trapped and the optimum way out is rather difficult to find. Although the SAC agreed with the Company that there is no legal regulation explicitly stipulating the duty to include in the Project a detailed description as regards the development task solution, the SAC does not consider it convincing and assessable to define the Project goals at a general level, allowing one to categorise an unlimited number of future engagements under that goal.

Therefore, it was not even to the Company's advantage that it had a binding assessment issued by the tax administration in respect of expenses that were subsequently claimed by the Company in the relevant additional tax returns. The SAC emphasised that in this case, the tax administrator did not examine for the purpose of a binding assessment whether the Project's formal requisites had been actually met. A failure to comply with the Project's requisites took precedence over the tax administrator's decision concerning the binding assessment.

To a certain extent, the judgment referred to above thus contributes to the current contradictory sentiments in society. On the one hand, research and development support is proclaimed at both national and EU levels but on the other hand, tax authorities and courts do not address the substance of the taxpayers' activity even though it can meet the definition of development. It is therefore necessary to answer the question whether the (sometimes exaggerated) adherence to the formal elements of the deduction, which is substantiated by eliminating potential speculations of taxable entities or by misusing the R&D deduction, is in line with the proclaimed support of R&D deductions and meets the requirements for unambiguity, comprehensibility and transparency as the essential elements of the current tax system.

In order to respond to the increasing requirements for applying the R&D deduction on an on-going basis, a sophisticated software solution, the R&D

Calculation Tool, has been developed. Click here if you wish to learn more about the tool's applicability in our clients' environment.

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Including VAT in the tax base for the calculation of property acquisition tax

The Financial Administration confirmed that the tax base for the calculation of property acquisition tax should not include value added tax, not even when the tax payer is the acquirer.

In mid-2016, the Supreme Administrative Court ("SAC") decided that the tax base for the calculation of property acquisition tax under the provisions effective until the end of October 2016 should not include value added tax ("VAT").

As we have informed you in the past, the Financial Administration then issued a statement that it would accept this decision of the SAC for the purposes of determining the tax base for the period from 1 January 2014 to 31 October 2016, when the payer of property acquisition tax was the transferor. However, the SAC did not deal with situations when the acquirer was the taxpayer. In this respect, the Financial Administration issued a statement on 24 November 2017 which confirmed that the above method would also be applied to cases where the acquirer (most commonly the purchaser) is the taxpayer and even for the period from 1 November 2016.

Based on the above decisions of the SAC and the approach of the Financial Administration, it is possible to file additional property acquisition tax returns for cases where VAT was included in the tax base. The additional tax return may be filed no later than three years of the day when the time limit for filing the tax return elapsed (i.e. currently / until the end of

January 2018, additional tax returns may be filed for cases where the time limit for filing the regular tax return elapsed on 31 January 2015).

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Application of the Amended Foreigners' Residence Act in Practice

Effective since 15 August 2017, Act No. 222/2017 Coll., amending Act No. 326/1999 Coll., on Foreigners' Residence in the Czech Republic, has come into force.

As we have already informed you, the greatest changes introduced by the amendment primarily relate to the transposition of EU directives into Czech law. The majority of EU member states have already transposed the directives to their systems, yet their practical applicability in the Czech Republic has so far been limited.

Intra-Corporate Transferees' Cards (ICT Card and Mobile ICT Card)

The cards make it possible to assign a non-EU country employee to the territory of the EU/EEA or Switzerland as part of the corporate group. In the Czech Republic, the ICT Card entitles the holder to residence and performance of work.

Investor card

Furthermore, the amendment introduces new residence institutes: the Investor card, designed for entrepreneurs planning to stay in the Czech Republic for over ninety days and intending to make a major investment in the Czech Republic, i.e. of a minimum of CZK 75 million, and to create at least 20 jobs for Czech and EU citizens.

Employee Card

The amended act also affects the practical application in respect of employee cards.

Institute of an Unreliable Employer

The amended act has introduced what is referred to as the institute of an unreliable employer. An employer may be designated as unreliable if, for example, they have run a debt to the Czech authorities, their activities do not comply with those registered in the Register of Companies, its registered office is fictitious etc.

Deloitte's view: As the Ministry has stated, no regularly updated list of unreliable employers exists. The employer referred to as unreliable will not be informed of the fact by the Ministry of the Interior but it may constitute grounds for rejecting a foreigner's application filed in relation to the employer.

The fact that the employer had been previously designated as unreliable is not a reason for designating the employer as generally unreliable in the future as well. Therefore, the assessment as to the employer's unreliability is always performed as part of the specific ongoing proceedings in respect of the application, which we see in a positive light.

Filing Applications at Representative Offices of the Czech Republic Abroad

The amended Foreigners' Residence Act gives Czech representative offices greater responsibility in accepting visa and residence permit applications.

Going forward, we will keep you updated about other practical implications of the amended act as well as about other immigration-related news.

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New Treaty between the Czech Republic and Korea Signed

On 12 January 2018, the Czech Republic and Korea (Rep.) signed a new Double Tax Treaty. Once in force and effective, the new treaty will replace the former Czechoslovakia - Korea (Rep.) Double Tax Treaty from 1992, in relations between the Czech Republic and Korea (Rep). The details of the changes contained in the new Treaty will be presented in the next issues of Report.

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Tax Treaty with Taiwan

The negotiations regarding the double tax treaty between the Czech Republic and Taiwan had been ongoing for seven years (the process started in 2010). The long-term negotiation process was attributable, inter alia, to the specific international-legal position of Taiwan which made it impossible to enter into a standard double tax treaty because the Czech Republic does not recognise Taiwan as an independent state since China has been making a long-term claim on its territory.

Each of the parties had slightly different ideas about how to tackle the situation. Taiwan is an important export destination for the Czech Republic, with, for example, large quantities of cars and luxury glass being exported there each year. At the same time, almost 30 Taiwanese firms have made investments in the Czech Republic, specialising namely in the manufacture of electronics.

The parties reached consensus at a meeting on 12 December 2017 through their representative bodies, the Czech Economic and Cultural Office in Taipei and the Taiwanese Economic and Cultural Office in Prague.

Based on the concluded treaty, unilateral measures will be prepared in order to reciprocally implement the provisions of the treaty. The Czech Republic is likely to implement the treaty through the adoption of a special act, the wording of which may also have a direct impact on the legal regulations on income taxation.

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