Tax&Legal Highlights

Czech Republic

Tax Changes in the Taxation of Investment Funds

In the March issue of dReport, we informed you about the planned change in the taxation of basic investment funds. The Senate proposed narrowing down the definition of the basic investment fund, excluding the funds the shares of which were listed for trading on a European regulated market but that failed to meet other conditions stipulated by law. The funds would be subject to the corporate income tax of 19% rather than being taxed at the current 5% rate.

The reason for the change was the Senate's effort to remove from the definition of the basic investment funds the funds that are only registered on a regulated market without actually performing investment activities. Pursuant to the amendment, the benefits of lower taxation should only be drawn by the funds that are active in making investments on financial markets.

During the legislative process, the Chamber of Deputies made an amendment to the draft stipulating that the basic investment funds include the funds listed for trading on a European regulated market with no corporate income taxpayer having any investment of 10% or more in the registered capital of the relevant investment fund; in order to meet the condition, investments of related parties that are corporate income taxpayers are considered to be investments of a single taxpayer; the condition is considered to be met even if the permitted investment in the registered capital is exceeded over a period shorter than a half of the taxation period or a period for which a tax return is filed or a period shorter than six months if the taxation period is longer than 12 months and if the fund is not involved in a trade under the conditions stipulated by the Trade Licensing Act.

The above-specified restriction will thus relate to the funds that are only considered to be basic investment funds under the Income Taxes Act due to the fact that they are listed for trading on a European regulated market and at the same time, they are owned within a group or by a limited number of owners, whereby the share of each owner is 10% or more.

The amendment will apply to tax obligations arising after the effective date of the Act, ie from 1 January 2019 as expected. We will keep you informed about any changes.

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Making Insurance Contributions on Behalf of "Outsourced" Employees

It is not necessary to have a legal relationship to make insurance contributions.

The Regional Court in Hradec Králové has addressed the issue of making social security and health insurance contributions from performances provided to employees of a different company. As the Income Taxes Act and contribution-related legislation treat these types of supplies differently, it is worth remembering the individual differences so that you do not make a mistake in remunerating "outsourced" employees.

According to the Income Taxes Act, an "employer" with the obligation to make personal income tax prepayments is (to put it simply) anyone who provides supplies related to the performance of dependent activities to anyone; however, according to contribution-related legislation, the statutory payment of insurance contributions on behalf of an employee was previously

based on the legal relation between the entity that pays the income and the person who performs the activities.

Since January 2014 in respect of social security contributions and since 2009 in respect of health insurance contributions, it has been sufficient for an individual to perform activities for you that give rise to income from dependent activities regardless of whether you have entered into a legal relationship with the person or not: you become an employer for the purposes of social security and health insurance contributions and you are obliged to make relevant insurance contributions and increase the base for calculating the tax prepayment on dependent activities to include the social security and health insurance contributions made by the employer.

To illustrate, imagine the situation where a car repair shop employee sells car care products, among others, as part of their employment relation with the car repair shop. The producer of the car care products rewards selected employees for good results with a watch worth CZK 3,000. According to the Regional Court's ruling, the producer of the car care products becomes an "employer" of these employees for the purposes of income tax prepayments on dependent activities and must be ready to deal with the extensive red tape related to tax payments.

It may not be clear whether the "outsourced employee" performs activities for you or whether it merely fulfils the instructions of its legal employer; however, in providing supplies to "outsourced employees", we recommend that you check whether you are subject to these potential other obligations.

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Intercompany Services as a Tax Deductible Expense

Management services or marketing support are the most common types of intercompany services. However, although it is economically justified, the provision of these services presents certain tax challenges that need to be taken into account. Namely given the fact that tax authorities focus more and more of their attention on the issue of intercompany transactions.

The majority of discussions held to this day on the tax consequences have primarily related to the transfer pricing setup. As a result, the intercompany pricing setup in line with the arm's length principle has become the norm and it has become customary for many groups to adhere to it.

Therefore, the major issue is the allocation ratio among individual entities and proving the actual provision of the services and whether they serve the purpose of attaining, securing and retaining taxable income generated by the company. These days, only a small portion of companies have a robust and perfect "defence file" in place that would serve as detailed evidence of what services were specifically provided (eg preparation of budgets, acquisition-

related advisory etc), in what scope (number of days, hours, when specifically etc), by whom (a specific employee the company providing the service) and with what deliverables (meeting minutes, e-mails, comments etc).

The precedent as to the scope in which the services received should be documented was set by a ruling of the Regional Court in České Budějovice (No. 10 Af 5/2016). In the ruling, the Regional Court sided with the tax administrator, confirming an additional tax assessment in excess of CZK 14 million including fines for failing to substantiate services from a related party.

However, the dispute has two levels. On the one hand, the tax audit contested the tax deductibility of the costs of advisory services received from the parent company. On the other hand, it contested the tax deductibility of legal services provided by a third party through the parent company, which subsequently rebilled the costs to the taxable entity.

As part of its defence, the taxable entity submitted a large amount of evidence which was intended to substantiate the provision of services by the parent company. For example, the evidence included presentations from training sessions, action plans, e-mail discussions and other records of communication with the parent company's representatives. Furthermore, the company submitted a series of invoices in respect of which the taxable entity also submitted, following the tax authority's call, the calculation of remuneration including a summary of the monthly payroll costs of the parent company's employees participating in the provision of the service.

However, the tax administrator ruled that the evidence contained *but a general description of the services, with none of the evidence submitted by the taxable entity showing the specific number of hours worked or the actual fee for the services provided and with individual appendices only referring to the specific invoice received without quantifying what proportion of the total amount invoiced is represented by the specific service.* Furthermore, the tax administrator argues that it is primarily impossible to allocate a specific expense (the fee for the service) to a specific service provided and, as a result, to deduct the expense for tax purposes. In respect of the calculation of remuneration to the parent company's employees, submitted additionally as appendices to the invoices, the court agreed with the tax administrator's conclusion in that *the calculations submitted were prepared by the tax entity retrospectively, for which reason they are not credible and eligible evidence of the facts presented in them.* The court also made similar comments on the retrospective conclusion of contracts, recalling the conclusion of Ruling of the Supreme Administrative Court Ref. No. Afs 8/2014-174, according to which it is insufficient to retrospectively assert that the entity's past actions were in line with a contract concluded later without substantiating the specific expenses relating to the specific provision of services.

As for the rebilling of costs for legal services, the court agreed with the tax administrator's opinion in that *the taxable entity failed to prove that it had ordered the legal services, what individual meetings specifically addressed, in what manner work was assigned and what deliverables were produced for it.* Although the entity provided, during the audit, for example a memorandum prepared by the external provider of the legal services which showed that certain services were explicitly related to the activities of the given entity, the tax administrator stated that the entity failed to bear the burden of proof in substantiating what specific contribution was made by the deliverable to the entity's activities and what benefits it had. The ruling

specifically refers to a legal service relating to a change to the entity's repayment schedule in respect of the bank which did not result in any changes to the schedule. The tax administrator argues that if the service were to be acknowledged as a tax-deductible expense, the repayment schedule would actually have to have been changed.

In its ruling, the regional court notes that it is only up to the taxable entity what evidence it submits to substantiate its assertions; however, at the same time, it points out that if, on the one hand, the cost incurred is not specified, and, on the other hand, it is not associated with a precisely specified provision of a service, the expense cannot be assessed to be tax deductible.

So far, this has only been stipulated by a regional court ruling. As the dispute has been advanced to the Supreme Administrative Court, there are still several months before we will know the ruling. However, other rulings on the provision of intercompany services have already been issued, containing similar arguments as the ones described above.

If the trend is upheld by the Supreme Administrative Court, it is high time for businesses to carefully prepare for this new era. It seems that contracts, invoices, samples of e-mail communication or unsigned meeting minutes will not be sufficient in substantiating services from related parties and it will be necessary to have many more documents at your disposal.

If you would like to learn more about the topic, come and join us for our presentation on 20 June 2018 from 11 a.m. to 1 p.m. as part of the debate "Management Fees – The Current Perspective and Judicature" hosted by the Construction Forum in cooperation with Deloitte.

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The Amendment to the Investment Incentives Act in Preparation

In a relatively short time after the major amendment (from 2015), another draft of the Investment Incentives Act has been prepared. It originated in response to the current economic situation, taking into account the requirement to amend the structure of projects so far funded by the government by way of investment incentives.

The purpose of the amendment is to increase the low number of projects which have attracted support in the area of technology and shared services centres. In respect of manufacturing projects, the goal is to focus on supporting production with greater added value. With regard to projects not fulfilling the greater added value criterion, solely those located in the territories of governmentally-supported regions are likely to obtain support; moreover, the beneficial treatment already applies to these projects under the current investment incentive regime. The amendment also seeks to respond to the unavailability of investment incentives for small and medium-sized enterprises, which was subject to criticism in the past. As such, the

amendment significantly minimises the required amount of investments in order to be eligible for the support. The legal obligation introduced by the previous amendment of having to create job positions under manufacturing investment projects is planned to be eliminated. This step appears to be logical, under the condition that projects generating greater added value will lower their requirements on the number of employees, and, on the other hand, will require greater professional qualifications and skills of employees.

A significant change introduced by the amendment involves distributing the criteria and obligations related to investment incentives among the Act itself and a governmental regulation. As such, the governmental regulation is supposed to determine in particular the minimum value of the required investment, the required number of newly-created job positions, and a particular method of providing evidence on the added value that is to be generated. The authors of the draft amendment have decided to make this change in an effort to maintain flexibility in amending the Act and the need to be responsive to the given economic developments. However, there is a question as to whether potentially frequent changes made by way of the governmental regulations will be sufficiently transparent for investors.

Finding the criteria based on which greater added value of manufacturing projects could be defined was a complicated task for the authors of the draft. Finally, the criterion was determined so that for 80% of employees of the investor aspiring to obtain the investment incentive, the salary has to be minimally equal to the average salary for the given region. In addition to this general criterion, the investors in question need to have (at least 2% of) employees engaged in research and development, or cooperate with a college/university or a research institute in terms of research and development. An alternative to performing research activities is employing minimally 10% of employees with a college/university degree. Currently, this parameter is inaccessible for most manufacturers.

The Amendment to the Investment Incentives Act is anticipated to come into effect in spring 2019. At the moment no changes in the criteria applicable to investment incentives recipients defined by the Act on Income Taxes are foreseen.

The amendment is currently subject to interdepartmental comments by individual ministries. A number of the comments are material, such as that all investment incentives shall be approved by the Czech government (so far, this only has applied to strategic investments). Judging by other comments on the defined criteria for monitoring greater added value, a follow-up debate and additional changes in the amendment draft can be expected. We will keep you informed on the developments in the preparation of the Investment Incentives Act.

As mentioned above, the amendment to the Investment Incentives Act is likely to become effective in spring 2019. We will keep you briefed on the actual state of the amendment.

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