Tax&Legal Highlights

Czech Republic

Current Situation as Regards the Tax Package Approval Procedure

The second reading of a bill amending various tax laws (the so-called Tax Package, Parliamentary Document No. 206) is to be included in the programme of the 24th session of the Chamber of Deputies, taking place from 4 December 2018. As we have already informed you in previous issues and in our regular webcast, it is unlikely that the original bill will be passed by the year-end. The possible effect of changes specified in the original bill is being addressed at present. The motions to amend which have been considered and are available on the website of the Chamber of Deputies (the deadline for their submission was 14 November) do not clearly indicate a comprehensive approach. The Ministry of Finance is preparing and debating (for example with the Chamber of Tax Advisors of the Czech Republic) a proposal for postponing the effective dates of individual provisions, with the preliminary indication that selected changes would only come into effect after the Act has been passed (or from the next month following the publication in the Collection of Laws), with other ones becoming effective for the next taxation periods subsequent to the Act taking effect. We have been closely monitoring the latest developments. A summary of details concerning the Tax Package (including the effective dates of relevant provisions) will be published after the second reading.

Contacts Details

Tereza Tomanová
Manager
Mobile: + 420 731 642 218
Email: ttomanova@deloitteCE.com

GFD's New Guidance Note on the Binding Assessment of Transfer Pricing and the Method of Determining the Tax Base for Permanent Establishments

On 9 November 2018, a new guidance note, D - 32, of the General Financial Directorate ("GFD") was published in the Financial Bulletin of the Ministry of Finance on the binding assessment of the pricing method between related parties and the method of determining a tax non-resident's tax base on activities performed through a permanent establishment (hereinafter jointly as the "binding assessments").

The new guidance note replaces Guidance Note D – 333 and, besides changes relating to the binding assessment of pricing between related parties under Section 38nc of the Income Taxes Act, it also newly incorporates information on how to proceed during a binding assessment in assessing the determination of a tax non-resident's tax base on activities performed through a permanent establishment under Section 39nd of the Income Taxes Act, which was introduced as early as 1 January 2018, yet in respect of which no accompanying methodology has been issued so far.

Although the guidance note is not legally binding, it serves as a clue for tax payers as to how the tax administration will address the issue of transfer pricing between related parties and the determination of the tax base/tax loss in respect of permanent establishments.

Shortening the Deadline for Filing an Application

A major change introduced by Guidance Note D – 32 in respect of binding assessments is the clarification of the deadline for filing the binding assessment application. In line with the previously applicable guidance note, it was possible to file the binding assessment application both during the taxation period for which it was being filed as well as subsequent to its expiry until the deadline for filing the tax return for the period. The new guidance note clarifies the interpretation of the deadline for filing the binding assessment application in that, with effect from 1 January 2018, binding assessment applications may only be filed for the taxation period during which the application is filed and for the subsequent taxation periods.

The change may have a significant impact on applications filed subsequent to 1 January 2018 in compliance with the rules stipulated by the replaced Guidance Note D – 333. However, it still applies that in situations where the payer used the same transfer pricing method or method of attributing profits to a permanent establishment in the preceding periods under corresponding terms, it may be assumed that if an affirmative ruling is issued, the tax administrator will, despite the invalidity of the ruling for prior periods, proceed similarly during tax audits as if the binding assessment had been issued.

Who are the Applications to be Submitted to and who Issues the Binding Assessment Ruling?

The new guidance note also specifies that taxable entities must submit binding assessment applications to the locally competent tax administrator. The application will be examined either by the locally competent tax administrator or the General Financial Directorate depending on the number of domestic entities to which the binding assessment relates. If the application exclusively relates to payers falling within the competence of a single locally competent tax administrator, the ruling will be issued by the respective tax administrator. If the payers in respect of whom the ruling is issued fall within the local competence of multiple tax administrators, the application will be examined by the General Financial Directorate. The same procedure will apply to bilateral or multilateral advanced pricing agreements.

Uncertainty about the Issuing of Rulings Persists

However, the new guidance note fails to eliminate tax payers' uncertainty regarding the deadline for issuing binding assessment rulings as the tax administrator's deadline for binding assessments has not been clarified or determined in any way.

The Administrative Fee Depends on the Number of Transactions or Permanent Establishments

The administrative fee for accepting applications is not newly fixed at CZK 10,000 per application: its amount will depend either on the number of transactions or permanent establishments assessed.

Assessing a Set of Unrelated Transactions

In respect of the binding assessment of transfer pricing between related parties under Section 38nc of the Income Taxes Act, major changes include the approach to assessing a set of closely unrelated transactions with related parties. Pursuant to the previously applicable guidance note, if the tax administrator had issued a negative ruling, the rejection of the application only related to the application itself, ie to all assessed transactions contained therein. Newly, the tax administrator will assess each transaction from among the set separately, independent of the others, with rulings issued on each transaction. These may be affirmative or negative regardless of the ruling on other transactions. The change in determining the administrative fee is also related to this update.

Assessing the Determination of the Tax Base in Respect of Permanent Establishments

With effect from 1 January 2018, Section 38nd of the Income Taxes Act also introduced a "binding assessment of the method of determining a tax non-resident's tax base on activities performed through a permanent establishment". Therefore, Guidance Note D – 32 specifies the methods for this type of binding assessment. In assessing the tax base for permanent establishments, the methods are similar to those in assessing transfer pricing. The primary basis are the tax non-resident's accounting books (tax records), with the tax base customary for tax residents in a similar situation taken into consideration. In determining the tax base, Section 23 (11) of the Income Taxes Act and Article 7 of the respective Double Taxation Treaty are applied, as are the general principles stipulated by the 2010 OECD Report on the Attribution of Profits to Permanent Establishments.

The assessment application must always be filed by the tax non-resident that has formed or will form a permanent establishment in the Czech Republic. If the tax non-resident generates profit in the Czech Republic through multiple permanent establishments whose activities are unrelated, each of them is separately assessed. However, if the activities of permanent establishments are inextricably linked, only one application may be filed and the permanent establishments will be jointly assessed. However, the administrative fee is again charged in a corresponding amount.

Contacts Details

Linda Scharingerová
Senior Manager
Mobile: + 420 731 619 483
Email: lscharingerova@deloitteCE.com

Karolína Staňková
Consultant
Mobile: + 420 703 893 484
Email: kstankova@deloitteCE.com

Effect of a new Czech and Korean double tax treaty

The new version of the double tax treaty between the Czech Republic and the Korean Republic is currently under discussion. The new double tax treaty shall replace the initial version of the treaty dating back to 1992 and substantially changes some areas. The new version provides a wider definition of a permanent establishment and changes the withholding tax rates on interest and dividends.

Service permanent establishment
The amended double tax treaty contains the definition of a service permanent establishment, which arises when services are performed on the territory of another contracting state for a period longer than nine months in any twelve-month period.

Taxation of passive income
Newly, the maximum tax rate of withholding tax on dividends shall be 5 percent for both legal and natural persons. According to existing rules, the dividends may be taxed at a 5 percent tax rate provided the recipient of the dividends holds at least a 25 percent capital share in the company distributing the dividends. The maximum tax rate of withholding tax on interest will be settled at 5 percent.

The withholding tax rate on royalties will stay unchanged, ie 10 percent. Zero percent withholding tax rate applies to any payments received as consideration for the use of, or the right to use, any copyright on literary, artistic or scientific work, including cinematograph films, films or tapes for television or radio broadcasting.

New rules for taxation of Capital Gains
A new paragraph (no. 4) of Article 13 *Capital Gains* introduces a provision for the taxation of gains derived by a resident of a contracting state from the alienation of shares or comparable interests. If more than 50 percent of their value is derived directly or indirectly from immovable property situated in the other contracting state, the gains may be taxed in that state.

Replacement of articles
Certain articles of the double tax treaty from 1992 were cancelled without replacement, ie Article 14 concerning the taxation of independent personal service or Article 21 concerning the taxation of the income of professors. The corresponding renumbering of articles was performed.

Additional option for elimination of double taxation
Another amendment concerns the elimination of double taxation. According to the new provisions, a Korean company shall be authorised to apply the offsetting method to the tax on dividends withheld by the Czech Republic. This benefit shall be available only if the recipient company holds a share of at least 25 percent in the share capital or voting rights.

New article in the treaty
A new Article 26 *Entitlement to Benefits* sets the rules for the revocation of benefits provided pursuant to the provisions of the double tax treaty if the relevant transaction was performed without any economic substance and with the only objective to obtain benefits.

The amended version of the Czech and Korean double tax treaty was concluded on 12 January 2018. The Senate of Parliament of the Czech Republic approved the ratification of the treaty on 17 October 2018. The negotiation about the treaty is on the schedule of the Chamber of Deputies of Parliament of the Czech Republic starting on 4 December 2018.

Contacts Details

Tomáš Ráček
Director
Mobile: + 420 731 198 071
Email: tracek@deloitteCE.com

Kateřina Krchnivá
Senior Consultant
Mobile: + 420 735 703 353
Email: kkrchniva@deloitteCE.com

A New Draft Act to Prevent the Double Taxation of Transactions with Taiwan

The Czech Republic has not concluded the standard international double tax treaty with Taiwan, as it has with the majority of other countries (as the Czech Republic does not acknowledge the territory of Taiwan as a state, it cannot conclude the contract).

In practice, this may have so far been to the detriment of Taiwan as a business partner as certain types of income generated by Czech firms and individuals coming from Taiwan had to be taxed in the Czech Republic regardless of whether the same transaction has already been taxed in Taiwan, and vice versa. As a result, several years of discussions have been held between the representatives of the two countries and, to prevent double taxation, the draft of a special act has been prepared, unilaterally introducing measures that typically form the content of international treaties. It is expected that Taiwan will introduce similar measures in respect of the Czech Republic.

The draft ensures the objective division of the right to collect income tax between the countries in situations where the source of the income is in one country and the recipient has residence in the other country. In practice, this includes, for example, income generated from construction, assembly and research activities, provision of technical advisory, use of patents, interest, equity investments etc. Furthermore, this also includes, for example, income from dependent activities, income of artists or athletes, and income from the use of copyright.

Based on the proposed legislation, double taxation will be eliminated in the Czech Republic through "simple credit". In practice, this means that Czech residents generating income in Taiwan will have tax calculated in the Czech Republic from total income reduced by tax paid in Taiwan; however, the maximum amount that may be deducted must be proportional to the Taiwanese partial tax base. Exemption may be applied to personal income from dependent activities performed in Taiwan, with the income exempt from taxation in the Czech Republic if it has already been taxed in Taiwan.

The basic principles of eliminating double taxation are set to be as follows:

•Personal and corporate income will be primarily taxed in the country of the person's tax residence. It will only be taxed in the other jurisdiction under the conditions expressly defined by the provisions of the act.

•Profit from the business activities based in one jurisdiction directly performed in the other jurisdiction through a permanent establishment may be subject to taxation in the other jurisdiction, with the draft act also taking into account "service permanent establishments" (if the activities performed in the territory of the given jurisdiction exceed 9 months in any 12-month period).

•Income from real estate and its use or rental may be taxed in the jurisdiction where the assets are located.

•Profit from the sale of shares or other equity investments whose value is directly or indirectly derived from more than 50% of real estate located in the other territory will be taxed by the source country (the "real estate clause").

•In essence, it will be possible to tax dividends, interest and licence fees in both jurisdictions. If the recipient is a beneficial owner residing in the other country, the tax in the jurisdiction of the income's source must not, under the rules of the given territory, exceed the following thresholds: •Dividends – 10% of the gross amount of dividends.

•Interest – 10% of the gross amount of interest. The rule does not apply to certain types of interest – eg, on loans for the acquisition of goods or equipment, and on loans guaranteed by governmental institutions (these are only taxed in the country of the interest recipient’s residence).

•Licence fees – 5% of the gross amount of licence fees for industrial, commercial or scientific equipment and 10% of the gross amount of other licence fees.

Contacts Details

Tereza Tomanová
Manager
Mobile: + 420 731 642 218
Email: ttomanova@deloitteCE.com

Petra Hechtová
Senior Consultant
Mobile: + 420 246 043 663
Email: phechtova@deloitteCE.com

The Court’s New View on the Utilisation of Clinical Studies as Part of the R&D Deduction

The Supreme Administrative Court (the “SAC”) has found against Vestra Clinics s.r.o. (the “Plaintiff”) in the matter of the possibility of utilising clinical studies as deductible items for research and development (“R&D”). Although the Court confirmed that clinical studies do meet the definition of R&D (as is, after all, indicated in Guidance Note D-288 and the Frascati Manual), the SAC ruled that the Plaintiff’s activities constitute the following of clearly defined instructions as prescribed by the clinical trial report, without containing any elements of novelty or clarifying scientific uncertainty.

The Court identified the elements with the clinical trial ordering party – the producer of the pharmaceutical – rather than with the Plaintiff. The SAC concludes that the Plaintiff merely carried out a specialised service for the ordering party: it did not bear the economic risk of the tested pharmaceuticals’ failure or affect the instructions, course or conclusions of the clinical trials and thereby did not meet the conditions for utilising the R&D tax deduction.

The Plaintiff, as a non-governmental health-care facility (a CRO), performed Phase-3 clinical studies, ie the systematic testing of pharmaceuticals on patients with the aim of demonstrating and verifying their curative effects and identifying any undesirable effects. In doing so, the Plaintiff is not an entity developing the pharmaceuticals: the ordering party (a pharmaceutical company) only makes use of its technical facilities and the high level of expertise of its employees (physicians) in order to carry out this development phase.

Following an analysis of the Pharmaceuticals Act, the SAC concluded that clinical studies are, generally by their very nature, activities that may be subordinated under R&D as they comprise the two defining traits of R&D – the existence of an element of novelty and clarification of scientific uncertainty. However, the SAC added that for the activities to be utilisable as part of the R&D deduction, the negative condition stipulated by the Act must also be fulfilled: ie, that the activities carried out in implementing the project must be performed by the payer itself rather than purchased as a service.

What the Frascati Manual and the Horizon 2020 Programme Say

According to the SAC, the actual research activity was performed by the ordering party (the pharmaceutical company), with the ordering party having developed the pharmaceutical, including the instructions according to which the testing phase was carried out by the Plaintiff. Therefore, as the Court ruled, the Plaintiff did not carry the increased level of business risk – it was borne by the ordering party. If the result of the clinical trial had been negative, the development of the pharmaceutical would not have proceeded to the next phase: ie, the pharmaceutical would not have been produced. According to the SAC, in this situation, the risk investment made by the clinical trial ordering party, rather than that of the Plaintiff, would have been marred.

The SAC thus refused to regard the clinical trial of a pharmaceutical performed by a CRO to constitute an independent R&D project whose input is a new active substance and the deliverable includes new findings on its actual effectiveness and safety. In its ruling, the SAC states that it regards clinical trials of pharmaceuticals to be eligible for a deduction only in relation to the development and subsequent commercial use of the pharmaceuticals as part of a single project. This is despite the fact that, globally, clinical studies are, as a rule, conducted by CROs (instead of pharmaceutical companies), which is also true of the Czech Republic.

Given this fact, it may be inferred that the authors of the Frascati Manual (the OECD’s underlying document for identifying R&D activities) as well as, say, the authors of the documents for the Horizon 2020 programme – the principal EU programme supporting R&D activities (where the documents expressly state that Phase 1-3 clinical studies meet the definition of R&D) based the documents on the fact that clinical studies are, as a rule, carried out by CROs rather than pharmaceutical companies themselves. It may also be inferred that in preparing Guidance Note D-288, lawmakers based their work on the Frascati Manual and, as a result, made it possible for Phase 1-3 clinical studies to be utilised in a deduction as they meet the definition of R&D (which, after all, the SAC confirms).

Considering countries that have included the R&D deduction in one form or another in their legislation, you will find that the legislation of many of the countries (eg, France) makes it explicitly possible to utilise specialised activities and costs incurred on Phase 1-3 clinical studies as part of the deduction. In view of the matters outlined above, it is evident that the lawmakers or authors of the documents were interested in supporting the activities and were aware that not all phases preceding the roll-out of a new pharmaceutical are typically performed by a single entity. Subsequently, it is not relevant which entity implements this phase of clinical studies and whether it is implemented independently or as part of a greater whole (eg, along with the development of the pharmaceutical).

Who Carries the Business Risk?

In the case in hand, the result is a situation where, on the one hand, it has been confirmed that clinical studies constitute R&D, but, on the other hand, an argument is put forward referring to the use of "risk capital" during the product's development and its indivisibility from the whole being developed. However, it would be a mistake to assume that the Plaintiff did not carry the risk of a business failure. Its risk capital does not consist of the costs of bringing the development of the pharmaceutical into Phase 3, but, from its perspective, if it had selected inappropriate patients, carried out an erroneous analysis and made an incorrect expert assessment of the effects of the pharmaceutical administered by the physician, or selected and used inappropriate assessment methods, the investment would have been marred considering the costs incurred. At this point, it should be noted that while the Plaintiff's business risk does not consist of the failure to roll out the pharmaceutical, it would be at risk of losing a contractual partner and its professional reputation on the market if it made an error during the clinical research into the pharmaceutical's effectiveness and safety.

If the situation is misread, there is a risk of generalising the conclusions and applying them, say, to the automotive industry, whereby it could be asserted that if the payer only develops a certain component for a brand new engine, it does not bear the business risk of the failure of the entire item being developed (in this context, the engine). However, in business practice, it is entirely customary that multiple entities gradually participate in the development of a single whole, with by far not all of them bearing the business risk of achieving the target parameters. However, the situation described clearly shows how sophisticated the product or process being developed is. Distinguishing chains of development phases and assessing them from the business risk perspective could, in practice, result in the restriction of using the institutes of a deductible item by a whole series of firms performing undisputed R&D activities.

A Surprising Interpretation Given the Existing Legislation

In respect of the argument of acquiring the activities as a service, which is not, from the perspective of law, a tax deductible expense, it can also be objected that the interpretation is outside the boundaries of the existing legislation. By defining the impossibility of including a purchased service in R&D, the lawmakers had a completely different situation in mind: if the pharmaceutical company purchased the results of the Plaintiff's work, the purchase would not be tax-deductible on the pharmaceutical company's part. However, in this context, the Plaintiff did not purchase the service: it supplied it itself in the form of new expertly acquired findings which the ordering party ordered from it, as is customary in the industry.

Through this ruling, the SAC presented its view on the eligibility of R&D activities for a deduction, concluding that the Plaintiff lacked both the possibility of creatively affecting the instructions, course and assessment of the clinical trials, as well as the elements of novelty and business risk connected with testing a proprietary pharmaceutical.

The authors of this article believe that the ruling brings new insight into the definition of R&D activities eligible for a deduction which does not, however, decrease tax payers' legal uncertainty. With regard to utilisation, the results of Deloitte's latest survey indicate that uncertainty arising from ambiguous conditions of this aid constitutes the most significant barrier for almost 60% of businesses.

Contacts Details

Antonín Weber
Director
Mobile: + 420 733 161 519
Email: antoweber@deloitteCE.com

Tomáš Holkup
Manager
Mobile: + 420 605 205 936
Email: tholkup@deloitteCE.com

Jakub Vrkoč
Senior Consultant
Mobile: + 420 736 428 819
Email: jvrkoc@deloitteCE.com