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Tax&Legal Highlights

Czech Republic

Breakthrough in the Existing Practice? A Company's Management may be Liable for Additionally Assessed Tax

As our experience suggests, the Financial Administration has been exerting significant pressure on tax collection, which is reflected not only in an actual increase in tax proceeds, but also, for example, in the number of tax seizures ordered. However, the Financial Administration sometimes seeks to collect tax in highly unorthodox ways. One such procedure has been reviewed by the Regional Court in Hradec Králové – Pardubice Office (the "Regional Court").

In the case in hand, tax (including accrued interest and fees) was additionally assessed in respect of an entity following a tax audit on the grounds of its failure to prove the VAT deduction entitlement due to not having submitted sufficient evidence demonstrating the performance of construction work. As the company did not pay the additionally assessed tax, it was subsequently unsuccessfully enforced in distraint proceedings. In most cases, the tax administrator would stop short at this point. However, in this case, the tax administrator proceeded to issue a guarantor's call in which it required that the company's statutory executive pay the tax arrears on its behalf. The tax

administrator inferred the statutory executive's liability from the following facts.

Consequences of a Failure to Act with Due Managerial Care

According to the tax administrator, the statutory executive erred in that it assumed that it would not be necessary to prove the performance of the construction work in the future. In the tax administrator's view, this error must be necessarily interpreted as a failure to act with due managerial care as the statutory executive was obliged to keep both a copy of the construction log and of the actual documents. As the tax administrator states, this error resulted in the company incurring detriment for which, if it is not settled, the statutory executive is liable and, as a result, he or she may be required to pay the additionally assessed tax.

A Positively Negative Regional Court Ruling

The Regional Court revoked the ruling of the Appellate Financial Directorate; however, this was not on account of the incorrectness of the whole structure of the statutory executive's liability. Instead, the Regional Court directly addressed the conditions under which the above stated liability obligation may originate.

Firstly, the Regional Court stated that additionally assessed tax **cannot** be automatically considered to constitute detriment incurred on account of a failure, if any, to act with due managerial care, the reason being that the amount of tax is determined by law and its payment is mandatory. Nevertheless, according to the Regional Court, interest and fees accrued in respect of the tax – ie, default interest or fees, whose amount is, in some cases, as high as the tax itself – could be considered to constitute such detriment. The Regional Court subsequently reviewed whether the statutory executive failed to act with due managerial care in not having stored the documents. The Regional Court arrived at the conclusion that no legislation stipulates such an obligation and, if the Financial Administration wished to infer a failure to act with due managerial care from this "negligence", it would have to provide a thorough justification thereof. Therefore, the ruling has been revoked for unverifiability.

Tax Audit Implications

The Appellate Financial Directorate has not filed a cassation complaint against the Regional Court's ruling. However, sooner or later, the Supreme Administrative Court is bound to address the issue of whether it is at all possible to infer management's liability for additionally assessed tax. Therefore, as the Regional Court has so far confirmed the theoretical possibility of recovering tax arrears from persons who have violated their obligation to act with due managerial care (ie, namely from all members of statutory bodies), it is possible that, in performing tax audits, the whole Financial Administration will, besides proving the facts resulting in the additional tax assessment, also focus on proving the violation of obligations by the entity's management.

Entities, or, to be precise, their elected bodies, should, therefore, consider what obligations may be expected of them by tax administrators in relation to their activities. The statutory body of an entity which, in relation to its activities, is at heightened risk of involvement (albeit unintentional) in VAT carousel fraud should focus on setting effective and efficient control measures in respect of its business partners.

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Announcing the Czech Republic's stance towards the EU's proposals for digital economy taxation

The Ministry of Finance has published on its website a brief summary of the Czech Republic's attitude to the proposals of the European Union concerning the taxation of so-called digital economy.

The Czech Republic opines that any long-term measures in this area need to be addressed at a global level as part of the OECD; therefore, it does not consider the short-term taxation of profits within the EU by introducing an interim (indirect) tax to be a conceptual solution. Some other countries (including Ireland, Finland etc.) have a similar (i.e. negative) attitude to the presented proposals. We will keep you informed of further developments in this area.

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Approaching deadline for an entry of beneficial owners information in the Beneficial Owners Register

An amendment to Act No. 304/2013 Coll., on Public Registers of Legal Entities and Individuals, effective since 1 January 2018, has introduced the Beneficial Owners Register (the "Register") in which all legal entities recorded in the Commercial Register need to record their beneficial owners by no later than on 1 January 2019. Other legal entities recorded in other public registers (including trusts) have to do so by 1 January 2021. What does this duty entail in practice, how complicated is it and what issues may arise?

Who is the beneficial owner?
Under Section 4 (4) of Act No. 253/2008 Coll., on Selected Measures against Money Laundering and Terrorism Financing (the "**AML Act**"), a beneficial owner means an individual who has a factual or legal possibility to exercise a direct or indirect controlling influence in a legal person, trust or other legal arrangement without legal personality status. The beneficial owner always refers to a specific individual (or a group of individuals). The AML Act further

specifies the facts that may indicate a beneficial owner. Nevertheless, the existence of such facts does not need to necessarily mean that the given individual is a beneficial owner. It is always necessary to assess whether the individual has the possibility to exercise a controlling influence.

Companies are obliged to identify the beneficial owner and keep up-to-date data for customer due diligence, including the facts constituting the beneficial owner status or other substantiation as to why the individual is considered a beneficial owner.

Beneficial Owners Register

The Register was established on a basis of a requirement of the 4th AML directive for the retention of data on beneficial ownership in a central register ensuring the availability of up-to-data and accurate information on ultimate beneficial owners to state bodies, Financial Intelligence Units (FIUs) and obliged entities when taking customer due diligence measures. As a matter of fact, it may be easy to disguise beneficial owners in complex corporate relations.

The Register is a non-public register. Information on beneficial owners is not provided along with a copy of an entry in a public register, nor is it published. The Register may be accessed by a limited yet relatively large scope of people including, apart from state authorities, representatives of obligated persons which have a duty to identify and verify beneficial owners as defined in the AML Act (this principally involves banks and other financial institutions).

The entire process is certainly not completed with the first entry of beneficial owners in the Register. The data need to be up-to-date and accurate.

What does a failure to enter the beneficial owner in the Register result in?

Sanctions have not yet been defined for a legal entity that does not disclose and enter the information on its beneficial owners in the Register by 1 January 2019. Nevertheless, this may pose an issue when the entity applies for providing financial services as pursuant to the AML Act, financial institutions shall conduct customer due diligence including the beneficial owner identification and verification. When the Register is used for the verification and a discrepancy is identified (or no information is found), this may complicate the provision of a banking product or service.

However, legal entities may encounter other issues in tendering for a public contract or applying for a grant from the EU funds. Pursuant to Act 134/2016 Coll., on Public Procurement, the public contracting authority should obtain data on the beneficial owner from the Register. Therefore, if this information is missing in the Register or is contrary to other declared data on the beneficial owner, the chances of the legal entity’s success in the tender procedure will decrease.

Based on an announcement published on the website of the Ministry of the Industry and Trade, the managing body of the Enterprise and Innovations for Competitiveness Operational Programme included a condition in calls published since June 2018, stating that **entities without beneficial owners recorded in the Register as of the date of the grant application will not quality for the grant under the programme**.

Is it complicated to make an entry in the Register? For some legal entities with a simple ownership structure, the identification of their beneficial owner and its entering in the Register will not be a major issue. Nevertheless, in our practice we have encountered companies (not only large ones) with such ownership structures, voting rights arrangements etc. that make it complicated to identify beneficial owners. A seemingly unambiguous term "beneficial owner" has a statutory definition entailing many difficulties. A classic example relates to companies co-owned by foreign legal entities.

Increased attention shall also be paid by companies operating in multiple countries (especially within the EU) in which similar registers and duties may also be in place but the definition of beneficial owners may differ and, consequently, other individuals may be entered in local registers. For example, a beneficial owner in the U.S. refers to a person holding 10% of voting rights, as opposed to 25% in most EU member states.

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October Vat news: VAT Act Amendment

As the discussion of the technical amendment to the VAT Act has been postponed, it may be expected that the relevant changes (eg, in respect of tax base corrections, VAT reduction in the event of irrecoverable receivables, taxation of bonuses to statutory executives and members of statutory bodies, differentiation of financial and operating leases or taxation of vouchers for the purchase of goods/services) will come into effect on 1 April 2019 at the earliest.

What is more, our information suggests that some of the proposed articles of the amendment are additionally anticipated to be modified in the second reading (eg, the taxation of bonuses to statutory executives and members of statutory bodies should be revisited). Therefore, it is difficult to predict to what extent the VAT Act will be amended.

The amendment should be debated by the Chamber of Deputies in the first reading in late October at the earliest. A similar schedule also applies to the amended Electronic Sales Records Act, based on which the application of a 10% VAT rate to draught beer is proposed.

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Conceptual changes in provisions regarding vacation time and minimum wage and more than 80 additional proposed changes effective already from 1 July 2019…

…are brought by the draft amendment to the Labour Code presented by the Ministry of Labour and Social Affairs. It is a more modest act compared to the very ambitious but unsuccessful draft from 2016, but it is still worth our attention.

Changes in the regulation of vacation time
The current regulation of vacation time in the Labour Code has been considered unsuitable for a relatively long time. The newly proposed concept should include the right to vacation time expressed in hours; its calculation will depend on the employee's working hours per week. In line with requirements arising from practice, it should be allowed to transfer vacation time exceeding the legally required four weeks to the next year. Changes will also affect the use of vacation time, its reduction in the event of unexcused absence etc.

Flexibility?
Unfortunately, the amendment does not include an explicit regulation of working from home (home office). The Ministry of Labour and Social Affairs responds to the voices calling for the introduction of more modern principles that would bring greater flexibility to our labour market by introducing "job sharing". This would refer to a set-up where two or even more employees share one job position and divide their working time themselves so that they cover the required working hours based on a written agreement between the employer and all the employees sharing the job position.

Delivery
Another problem often encountered in practice has been the discrepancy in the deadlines related to the delivery of labour-law documents. The Labour Code should now be made compliant with the delivery conditions of the Czech Post, i.e. the period for picking up a letter stored at the post office (due to failure to deliver it personally to the employee) will now amount to 15 calendar days (instead of the current 10 business days). Employees will also be required to notify their employer in writing about any change of address where their employer can send documents to them.

Minimum and guaranteed wage
Another proposal concerns the introduction of a fixed mechanism for the valorisation of minimum wage (as well as the lowest levels of guaranteed wage). The objective of the proposal is to set up a valorisation mechanism so that the minimum wage is increased regularly and its amount can be estimated easily and in good time. According to the proposed amendment, minimum wage should amount to 0.548 times the average gross monthly salary in national economy for the calendar year before last (rounded up to the nearest hundred).

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Research and Development Deduction: The Fundamental Ruling

The Regional Court in Hradec Králové ruled in favour of the plaintiff (ENERGO CHOCEŇ, s.r.o.), revoking the contested ruling and referring the matter back to the Appellate Financial Directorate for further proceedings.

The ruling fundamentally clarified the legal term "commencement of the implementation of a research and development project", expressed the impossibility of generalising conclusions for individual taxation periods and, last but not least, expressed the necessity of appointing an expert for selected assessments.

In a dReport article in July, we discussed the upcoming news in respect of the research and development ("R&D") deduction, which should result in decreasing the tax uncertainty and administrative burden for tax payers. The ruling issued by the Regional Court in Hradec Králové (the "Regional Court"), ref. no. 52 Af 18/2016-181, is further good news for payers utilising, or intending to utilise the R&D deduction. The ruling refers to an additional corporate income tax assessment and the related fine for the 2009 and 2010 taxation periods for failing to bear the burden of proof as a consequence of not submitting all business documentation, failing to meet the formal and material requirements of the R&D project and not substantiating the presence of an appreciable element of novelty and the necessity to clarify technical uncertainty.

Highlights of the ruling:

- The payer is not obliged to utilise all costs incurred in relation to R&D. In contrast, they may only deduct costs in respect of which they are able to bear the burden of proof before the tax administrator, taking into account their demonstrability, recording and administrative requirements.
- The Regional Court stated that *"it may be concluded that* ***the implementation of the R&D project is commenced*** *upon* ***the approval of a written R&D project draft*** *by the authorised person, in which the processor defines the underlying goals, methods and planned costs of the R&D project and other basic details as stipulated by law."*
- Following the approval of the R&D project, the payer must maintain separate accounting records about the R&D project.
- It is solely at the discretion of the payer which activities they will perform prior to the date of approving the R&D project; the costs relating to these activities are automatically non-deductible.
- The Regional Court expressed the impossibility of generalising conclusions for individual taxation periods without demonstrating clear links. This was a response to the generalisation of conclusions whereby the tax administrator inferred from the wording of the internal guideline prepared by the payer that it retrospectively gave

rise to the R&D project. It also applied this conclusion to the R&D projects that were, however, related to the period subsequent to the preparation of the guideline.

- In its previous rulings, the Regional Court had already confirmed the above stated necessity of appointing an independent expert, who will themselves assess the sufficiency of the documents submitted and the presence of an appreciable element of novelty and the clarification of technical uncertainty. This is owing to the fact that tax authorities do not have sufficient expertise to be able to assess the appreciable element of novelty, if any, and the clarification of technical uncertainty.
- The Regional Court also addressed the amount of evidence that the payer must submit in order for the appointed expert to be able to prepare the expert opinion for tax authorities. Unless the payer has been demonstrably completely inactive during the tax proceedings, it is fully at the discretion of the expert to assess whether the documents submitted are sufficient for formulating the relevant expert opinion.

Besides the "Fortell", "Abadia" and "Vestra Clinics" rulings, the above stated ruling is the next in line that specifies the not very clear legislative provisions, increases tax certainty for payers and, last but not least, may also be beneficial for assessing contentious issues from the tax administrators' perspective. The full clarification of the as yet not very specific phrase "commencement of R&D activities" hopefully removes the speculations that, during tax audits, R&D activities could be considered to commence, for example, upon the signing of a contract with a customer, receiving an order, or an internal meeting of management regarding the planned activities.

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