



## Tax&Legal Highlights

### Czech Republic

#### Interest in Trust Funds on the Rise

The legal institute of trust funds has recently become more attractive, namely owing to the media hype surrounding the former minister Andrej Babiš. However, it should be noted that Andrej Babiš was neither the first nor the only one who made use of the option of organizing his asset portfolio via a trust fund. The number of trust funds created between 2014 and 2016 exceeds six hundred and the interest in the institute keeps rising.

Trust funds, which are traditional and long-standing legal institutes namely in the Common law system, were incorporated in Czech law by the New Civil Code with effect from 1 January 2014. In connection to its introduction, amendments to related legal regulations (eg tax and accounting regulations) were made. Notwithstanding its lack of legal personality and a registered office, a trust fund is considered to be a due reporting entity and corporate income tax payer obliged to be registered with the Tax Authority for the Capital City of Prague (territorial office for Prague 7).

## **Ambiguity of the New Legislation**

Before the New Civil Code came into effect, a major political debate took place regarding the removal of the institute from the Czech Republic's legal system. The reasons for the proposed removal primarily included the ambiguous new legal provisions and concerns about trust funds being abused for the calculated diversion of assets in order to achieve fully anonymous ownership or to circumvent related tax liabilities. More than three years later, it appears that the labor pains of the new legal and related provisions are gradually subsiding. Given the short period of existence of trust funds, it is currently not possible to rely on judicature in contentious situations; however, efforts have been underway since 2014 to eliminate ambiguities in legal, tax, accounting and other related legislation governing trust funds.

Ambiguities in the legislation governing trust funds have also been identified in relation to tax aspects although trust funds as stipulated by Czech legal regulations do not carry any special tax relief compared to similar funds abroad. Interpretation-related tax issues result primarily from the trust fund lacking legal personality and the ambiguous definition of relations among the trust fund, its founders and the beneficiaries deriving benefit from the fund's assets and profit. Before the relevant legal regulations actually came into effect, the Chamber of Tax Advisors actively initiated meetings with representatives of the Czech Tax Authorities, with a view to clarifying the substance of the related ambiguous tax regulations under discussion. Therefore, since the very beginning of the existence of trust funds, the interpretation of the regulations has been discussed in respect of the trust fund's tax position, tax depreciation and amortization of assets placed in the trust fund, tax consequences of the costs paid from the resources allocated to the trust fund or increasing the trust fund's assets, taxation of supplies to the beneficiary from the fund's assets or profit, taxation of the fee to the fund trustee etc. In this respect, the approach of the Czech Tax Authorities may also be assessed in highly positive terms. In early 2014, the General Financial Directorate issued a formal guideline regarding the registration of trust funds as taxpayers, with the Czech Tax Authorities interested in addressing other contentious issues concerning the taxation of trust funds as well. Provisions were ambiguous not only in relation to income tax but also to VAT, tax on the acquisition of immovable assets etc. The highly positive thing is that the interpretation of multiple contentious issues has already been unified as part of the given communication. However, there are tax issues in respect of which we still lack affirmative and definite answers. We have no other choice but to wait for related judicature, which is still nowhere in sight.

## **Compulsory Registration of Trust Funds**

The amendment to New Civil Code No. 240/2016 Coll., introducing compulsory registration of trust funds in a formal trust fund list with effect from 2018, has not diminished the attractiveness of trust funds. As a result, trust funds will come into being on the day they are incorporated in the newly established register of trust funds, which should work on the same principle as the Register of Companies. Similarly, the designation of the beneficiary of a trust fund established for private purposes will also become effective on the day when the beneficiary is registered in the non-public part of the trust fund register.

## **Exemption of Profit Shares Newly Possible for Trust Funds as Well**

Another step towards making trust funds more attractive in terms of the tax burden is currently in the last stage of the legislative process. The "Tax Package", abolishing the double taxation system in respect of trust funds holding equity interests in their portfolios, has been approved by the President and is awaiting promulgation in the Collection of Deeds. Double taxation (ie the taxation of profit from the business activities of an enterprise and the subsequent taxation of the allocation of a profit share to the trust fund) placed trust funds at a disadvantage compared to business corporations which may be exempt from the "dividend tax" upon the subsequent allocation of profit provided it meets relevant conditions (ie the amount of the share, period of holding and legal status). On the anticipated effective date, 1 July 2017, discrimination will be eliminated and all profit shares allocated to the trust fund whose payment will be decided subsequent to the above date may be exempt from the tax provided the above stated conditions are met.

In respect of the institute of trust funds, this presents an interesting opportunity for handling asset portfolios, namely in view of the future resolution of family relationships or the legal protection of assets against risks arising from business activities. If the institutes become common practice as part of our legal environment, with interpretation ambiguities eliminated in other respects as well, trust funds will become ordinary and popular institutes which may be used in positive terms by any of us, just like abroad. The uncertainty in using trust funds as new legal institutes which we have been dealing with in the past 2-3 years could thus be fully eliminated.

## **Upcoming Changes in Income Taxation**

**The Ministry of Finance has published further material regarding the new Income Taxes Act. The Legislative Department of the Ministry of Finance has published a draft version of the material entitled "Outline of the Innovative Solution Regarding the Regulation of Income Taxation and Income-Related Insurance Payments" for public consultation. The material provides a theoretical background to the concept of the new Income Taxes Act.**

In addition to the matter that have already been outlined, we would like to point out the following information:

- Currently, one version of one Income Taxes Act is generally preferred to having two separate acts for individuals and legal entities.
- In terms of individuals, the draft proposes a reduced number of partial tax bases, which would inter alia result in a unified tax treatment of income from business activities and lease. The material does not provide any further information regarding the impacts that the new changes will necessary have on the interconnected system of social security and health insurance contributions.
- The material describes system exemptions that should be included in the upcoming act (eg random income of individuals) and simplified tax regimes for certain situations (eg lump-sum expense charge-offs). Non-systemic issues (eg the amount of the tax rate or the majority of the existing tax exemptions) should be included in the act depending on the political perspective.

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- The material also considers the possibility of introducing group taxation for legal entities.
- The corporate income tax base should be based on accounting records, however, the relatively substantial amendments will effectively result in "tax accounting records".

For the new Income Taxes Act to become effective, the Tax Administration will have to implement a new IT system, and the institutes of self-assessment and individualization, ie the break-down of tax accounts into individual physical persons – employees, will have to be introduced. Given the long-term implementation period of such projects, it is apparent that the new act will be an extremely long-term project.

### **Everybody May Be Held Liable for VAT Fraud! Do Not Pay Taxes for Others!**

**Fight against tax evasion is one of the issues handled by the tax administration in the Czech Republic and across European Union. A large portion of ongoing tax audits is initiated due to suspected involvement in a VAT fraud. The tax administration uses data provided by the businesses themselves to identify any involvement, although unconscious, in a VAT fraud.**

The primary information sources include statutory Local Sales and Purchases Reports as well as information provided by companies in good faith on the basis of unofficial requests of the tax authority in the form of e-mail or in the course of a tax audit. Our experience indicates that the more information companies provide on business activities, the longer the tax proceedings usually take and the data disclosed by companies are often used by the tax administrator as evidence that companies did not act in good faith. If the tax administrator proves in the tax proceedings that a company did not act in good faith, the company will have to pay the VAT for the entity committing the fraud.

It is obvious that any business or entrepreneur may establish a cooperation with a business partner that is involved in a VAT fraud. As an illustrative example, we could mention the case from May 2017 when the General Financial Directorate itself purchased mobile phones for internal purposes from a company involved in a VAT fraud. The information which was subsequently issued by the General Financial Directorate indicates that if a company is able to prove that it has made every effort to prevent its involvement in fraud, it will not be held liable for the outstanding VAT.

There are currently no entrepreneurs, companies and, ultimately, state organizations that would not be exposed to this risk.

For a long time, the term "tax fraud" has referred to not only fictitious but also actual supplies of goods in a supply chain in which one of the suppliers will supply the required goods but will not declare and pay the VAT applicable to the transaction. Although other entities in the supply chain are not aware of any such activity, the tax administrator may conclude that the relevant entity could or should infer from the information which was available to it or from the non-standard nature of the transaction that a failure to pay VAT may arise. If the tax administration demonstrates that the entity did not act in good faith, the entity as a guarantor may be obliged to settle the unpaid

VAT, or the entity's related claim for a VAT deduction does not have to be recognized. As a matter of fact, the entity may be required to pay VAT for another company although it has paid all taxes as appropriate.

**How should one avoid being unconsciously involved in a VAT fraud and paying taxes for others?**

If a tax administrator wants to additionally assess tax or does not want to recognize a claim for a VAT deduction due to involvement in fraud, it will have to prove that an entrepreneur or company should or could have known that its supplier or customer is involved in a VAT fraud. This fact is inferred by the tax administrator on the basis of the control procedures performed by the entrepreneur in concluding the transaction and as part of cooperation with a business partner. The tax administrator predominantly focuses on what control measures were established by the entrepreneur and whether appropriate attention was given to them to prevent the risk of being involved in a fraudulent chain in which a failure to pay VAT occurred.

What indicators are to be monitored by companies? Aside from reviewing VAT registration, unreliable payers and published accounts, companies should also focus on the information which is available in the Register of Companies, the Trade Register as well as the Insolvency and Enforcement Register. With respect to the absence of good faith, tax administrators also draw attention to the fact that it may also be considered suspicious when a business partner of the audited company does not publish its financial statements or is a newly incorporated company or a company without the necessary business licenses, or when its statutory bodies are composed of foreigners or young people or when the transaction price is too low. There is a wide range of relevant and available information which differs depending on the business sector in which the company operates and on the manner in which its business activity is commonly realized.

The results of this review are to be demonstrably recorded for the purpose of a tax audit, if any. The tax administrator will be otherwise exposed to the risk that despite being prudent in respect of its business partners and having sufficient control measures in place, it will not be able to demonstrate this to the tax administrator and, ultimately, it may be deprived of its claim for a VAT deduction. The relating measures should also be reflected in contracts with business partners.

Launching the VAT risk management system, which should certainly be part of risk management of any entrepreneur or company at present, is a comprehensive matter. It is therefore advisable to give appropriate attention to this issue.

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