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Tax services

# Tax news Ernst & Young

## Contents:

### Corporate and Personal Taxation

Judgment of the Czech Supreme Administrative Court regarding the burden of proof in the case of transfer pricing assessments by the tax authority

European Commission publishes final Common Consolidated Corporate Tax Base proposal

Health insurance - electronic filing of documents

### Value Added Tax

Decision of the Slovak Supreme Court on Commercial Reason for Transactions

Ruling of the Slovak Supreme Court on the Slovak VAT regime for sale of goods held under the customs warehousing regime ("Profitube")

Judgment of the Slovak Supreme Court dealing with the right to VAT refund in the case of import of goods

The EU Council formally adopted the Implementing Measures Regulation

Tax Authorities - Results of 2010 tax audits



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## Judgment of the Czech Supreme Administrative Court regarding the burden of proof in the case of transfer pricing assessments by the tax authority

In this article we inform you on a recent decision of the Czech Supreme Administrative Court, which may be relevant for consideration in Slovakia, due to similarity of the respective legislation.

### *Subject of the dispute*

A taxpayer leased commercial premises in Česká Lípa to a related party for rent X and an apartment to another related party for zero rent. In both cases, the tax administrator judged that the market rent was higher and increased the tax base by the relevant difference.

When deciding on the market price, the tax administrator gathered information on the level of rents charged for leased premises in the same location and at the same time and selected its referential price.

The taxpayer lodged an objection that the premises it was leasing were inconvenient and in a rundown condition, which it substantiated with photographs taken when the lease had already expired and the premises been vacated. Accordingly, the taxpayer requested the tax administrator to discount those premises that were in better condition than the taxpayer's. The tax administrator obtained testimony from an expert to the effect that, during the term of the lease, the premises were not completely run down and so were suitable for leasing. On this basis, the tax administrator concluded that the taxpayer had

not substantiated its claim with regard to the poor condition of the premises and ignored the claim in making its decision.

### *Court decision*

In its decision, the Czech Supreme Administrative Court held that the tax administrator bears the burden of allegation and the burden of proof regarding all the conditions for application of adjustment to transfer prices. This means that the tax administrator must demonstrate that the case involves related parties, an agreed price and a referential price, i.e. a price which would be agreed on between independent parties in regular commercial relations under the same or similar conditions.

In order to ascertain the referential price, the tax administrator must be able to meet the burden of proof in relation to all the decisive factors. If the administrator specifies a referential price from information it collects on genuinely attained prices, it must duly investigate to what extent these prices would be attained under the same or similar conditions and, if these conditions differ, must make an appropriate correction to the referential price.

The tax administrator's burden of proof also relates to ascertaining the circumstances under which the related parties agreed on a price. If ambiguities arise regarding decisive factors, the tax administrator must arrive at conclusions which are the most advantageous for the tax entity within the context of the specific facts of the case.

After the tax administrator has met the proof, the taxpayer must be given time and space in which to satisfactorily explain the difference between the prices.

In the case under consideration, it is not sufficient for the tax administrator simply to credibly contest the taxpayer's claim regarding the condition of the leased premises - something the tax administrator succeeded in doing. The administrator must also substantiate this condition or at least substantiate that the condition was not worse than a certain level as ascertained, and must base the referential price on this level. If the tax administrator is unable to ascertain the condition of the premises, it must base its conclusions on the taxpayer's claim. The taxpayer does not bear any burden of proof in this case.

### *Commentary*

This judgment provides a basic guideline for allocation of the burden of proof between the taxpayer and the tax administrator in disputes on transfer pricing. It is not sufficient for the tax administrator to contest a claim made by a taxpayer: the tax administrator is required to itself definitively substantiate all the facts which are decisive in respect of a modification of the tax base.

We wish to note here that Slovak courts or tax administrators are not bound by the decision of Czech courts and the respective legislative provisions are not identical. Nevertheless, the provisions of the current Slovak legislation are similar to those referred to by the Court. Consequently, we believe that the arguments detailed above could be relevant in a transfer pricing dispute in Slovakia.

If you have any questions regarding transfer prices, please contact the author of the article or your partner or manager at Ernst & Young.



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## European Commission publishes final Common Consolidated Corporate Tax Base proposal

We wish to inform you that the European Commission published the proposal for CCCTB on 16 March 2011.

As we commented in our previous Tax News, the objective of the proposed legislation is to create the possibility for companies to pool profits and losses amongst their group members and to minimize tax compliance costs by introducing a "one-stop-shop" concept.

### *Reaction of Member States*

While countries such as Germany and France have supported the CCCTB initiative, it has not enjoyed

universal support among Member States. Slovakia and some other Member States perceive these proposals as an infringement of their tax sovereignty.

As a side-effect, the Directive has already demonstrated a very significant impact on the probable future design of corporate tax systems in EU Member States. Some smaller Member States have signaled their interest in using the Directive as a blueprint for future corporate tax reforms. This would not necessarily lead to full harmonization but it could start the process of aligning tax systems in many Member States.

### *Implications for taxpayers*

Whilst earlier proposals for a CCCTB focused on the needs of large multinational groups of companies, the Directive as finally proposed encompasses all

companies, regardless of size. It should also be noted that the CCCTB is an optional regime for companies.

Due to the strict "in-or-out" principle, once a group of companies opts to use the CCCTB, the member companies are no longer able to utilize individual Member States' incentives for areas such as Research and Development or beneficial accelerated depreciation. Therefore, it is of the utmost importance that companies not only assess the appropriate apportionment formulae when making a European tax rate comparison, but also consider issues such as the loss of specific incentives.

Please click [here](#) if you would like to receive a more detailed EU tax alert dealing with the CCCTB proposal. For more information please contact the author of the article or your partner or manager at Ernst & Young.



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## Health insurance - electronic filing of documents

The Slovak Healthcare Surveillance Authority has recently stipulated two new obligations for filing documents in electronic form, both of which apply to companies and individuals employing three or more employees registered in one health insurance agency. The obligations are embedded in the amended methodological guidelines issued by the Healthcare Surveillance Authority.

Thus, the employers concerned are obliged to file notices of changes of status of the insured employees in electronic form. The notices should be filed within eight days of the change. In addition, the respective employers are also required to file reports on prepayments for health insurance in electronic form, in order to comply with the obligation valid from 25 January 2011.

The structure of the notice and report in electronic form, together with all related information and instructions, is detailed in the relevant guidelines.

Both the above obligations are applicable as of the January 2011 reporting period.

If you would like more information on this issue, please contact the author of this article or your partner or manager at Ernst & Young.



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## Decision of the Slovak Supreme Court on Commercial Reason for Transactions

The Slovak Supreme Court (“the court”) recently issued Decision No. 3 Sžf 25/2010 dealing with the commercial reason for transactions as a main identifier of the supply transaction for VAT purposes in a chain of transactions.

### *Situation*

The Slovak VAT payer (“the Company”) operates a card scheme. On the basis of contracts with its partners (entities operating gas stations, further as “the partners”), the customers of the Company (“the customers”) were allowed to purchase goods at the respective gas stations without payment. They used a card issued by the Company on which the purchases at the gas station were recorded in the name and on the account of the Company.

The gas stations of the partners issued a bill from the cash register to the customers of the Company but did not receive any compensation in return for the goods purchased. Subsequently, the partners requested the payment from the Company on the basis of a summary of transactions (not a VAT invoice) and the Company charged its customers for the goods supplied.

The tax authorities claimed that the Company had no right to deduct input VAT as it did not have available proper invoices from its suppliers (i.e. the partners). Furthermore, the tax authorities argued that the goods were actually supplied from the partners directly to the customers and, therefore,

the summaries of transactions on the basis of which the Company deducted the input VAT represented only the financial settlement. In other words, the bills from the cash register issued by the partners to the customers constituted the invoices for VAT purposes.

### *Argument of the parties*

The main question concerning the parties was whether the supply of goods was made from the partners directly to the Company or to the customers of the Company. The tax authorities claimed that, as the customers had the immediate right of disposal of the goods as the owner, the supply had to be made directly from the partners to the customers.

However, the contracts concluded between the Company and the partners did not state that the partners supply the goods / services to the customers directly. On the contrary, the contracts explicitly stated that the Company buys the respective goods / services from the partners and subsequently sells them to its customers. The Company derives its profits from the higher price received from its customers and the lower price invoiced by the partners. In addition, the Company is fully responsible for the quality of the goods sold to the customers and bears all the associated business risks.

It was also noted that the Company did not receive the regular VAT invoices from its partners due to an error in the software system of the partners. After rectification of this error, the Company received the VAT invoices from the partners and the customers no longer received the bills from the cash register (only a kind of delivery note).

The tax authorities also claimed the card issued by the Company to be a credit card. The Company,

however, proved from the contractual documentation that the card was not intended to serve for payments but solely to record the goods / services purchased at the gas station.

The tax authorities referred also to the judgment of the Court of Justice of the European Union (“CJ EU”) in the case of C-185/01 Auto Lease Holland BV and applied its conclusions to the case of the Company. The court accepted that there might be some features in common, but that the economic reason behind the transactions in case no. C-185/01 and the case of the Company were different. In the case of Auto Lease Holland BV, the supply of fuel was a secondary supply; but in the case of the Company it is the main subject of its business.

### *Decision*

The court ruled that the economic nature of the supplies forming a part of the transaction in question should be the decisive criterion, i.e. that the immediate business aim of the parties entering into the respective transaction should be taken into account. The Supreme Court further held that, if the transaction has a rational business reason, the tax authority may not reclassify it, unless they are able to prove that there is a judgment of the CJ EU supporting them in so doing.

In the light of the judgment, the Supreme Court seems to accept that in the economic reality, there was in fact a chain of transactions: supply of the goods by the partners to the Company followed by the supply to the customers.

However, the Supreme Court did not answer the question of whether the Company can apply the right to deduct the respective VAT in the absence of

a VAT invoice. Nonetheless, the Court indicated that unless there is any exemption in the judgments of the CJ EU from the formal invoicing requirements which could apply to this case and the respective invoices had formal deficiencies, the right to deduct would likely be disallowed.

### *Practical considerations*

Even if the structure of the transaction is not absolutely clear and the respective VAT treatment is not straightforward, the tax authorities must allow the taxpayer to prove the economic reason for the transaction and to take it into account. In addition, if the transaction evidently has a reasonable business

purpose, the tax authorities may not reclassify it and set it apart from the common VAT system, unless there is a decision of the CJ EU allowing such treatment.

If you have any queries regarding this topic, please do not hesitate to contact the author of this article or your contact partner or manager at Ernst & Young.



## **Ruling of the Slovak Supreme Court on the Slovak VAT regime for sale of goods held under the customs warehousing regime (“Profitube”)**

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We wish to inform you of the decision of the Slovak Supreme Court dealing with the Slovak VAT regime applicable to the sale of goods placed in the customs regime of customs warehousing prior to their release into free circulation.

### *Situation*

A VAT payer sold imported goods warehoused within the territory of Slovakia prior to their customs clearance into free circulation here. The VAT payer did not apply Slovak VAT on the transaction, in the belief that the transaction was outside of the scope of Slovak VAT. Inter alia, the VAT payer argued that VAT cannot be chargeable on the sale prior to the goods being cleared into free circulation.

In the course of a tax audit, the Slovak tax authorities challenged this approach. They argued

that the transaction was subject to Slovak VAT as it represented a supply of goods performed within the territory of Slovakia (setting aside the fact that goods are also subject to import VAT at some future point in time). The customs status of goods and the customs regime of the goods are not pertinent in this respect.

### *The decision and its practical considerations*

The Supreme Court ruled in favor of the VAT payer. The Court argued that, in accordance with the Council Regulation on establishing the Community Customs Code, the goods prior to their clearance into free circulation cannot be considered as Community goods. As a result of this, their sale cannot be subject to Slovak VAT. In addition to this, the Court rejected application of the principle of territoriality, as claimed by the tax authorities, as its application would be contrary to the international customs agreements and the agreements establishing the World Trade Organization.

We regard this decision of the Supreme Court as somewhat controversial. Rejection of application of the principle of territoriality could represent a breach of the basic principles of the European

VAT legislation. In this respect, Article 156 of the VAT Directive explicitly provides Member States with the option to exempt from the scope of VAT those supplies of goods which are intended to be placed under customs warehousing arrangements or inward processing arrangements. This implies that transactions with goods under these arrangements and within the territory of the EU should, in the ordinary course of events, be subject to VAT. This liability is separate from the obligation to pay import VAT upon clearance of the goods. For completeness, it should be noted that Slovakia has not exercised the option to incorporate into its VAT legislation any provisions permitting the exemption of sales of goods prior to their clearance into free circulation.

If you feel that the Profitube ruling could have an impact on your business activities, we would be pleased to discuss with you the potential implications and related risks. In this case please contact the author of this article or your partner or manager at Ernst & Young.



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## Judgment of the Slovak Supreme Court dealing with the right to VAT refund in the case of import of goods

The Slovak Supreme Court recently issued its decision on the entitlement of a foreign person to request refund of VAT paid in Slovakia on imported goods.

### *Situation*

The foreign person imported goods from outside the EU and the customs procedure was performed in Slovakia. The imported goods were subsequently transported by the foreign person to the customer in the Czech Republic.

The foreign person filed a request for refund of the VAT paid in Slovakia on the imported goods. However, the Slovak tax authorities refused to refund the VAT, arguing that the foreign person did not meet the statutory requirements for VAT refund for the supply of goods with the place of supply in Slovakia performed in the period for which the VAT refund was requested. The Slovak tax authorities

were of the opinion that the transport of the imported goods to the Czech Republic should be considered as a separate supply of goods where the place of supply should be in the country where the customs procedure was performed (as transport of the goods started outside of the EU).

### *Decision*

The Supreme Court ruled in the favor of the foreign person, arguing that import of goods and supply of goods are two different transactions with different attributes.

According to the Supreme Court, it is questionable whether an actual transaction was performed in Slovakia as it is not proved whether ownership to the imported goods was transferred to the customer in Slovakia or in the Czech Republic. The Supreme Court ruled that, for a supply of goods in Slovakia to be performed by the foreign person, the economic ownership of the imported goods must be transferred from the foreign person to the customer within the territory of Slovakia. Otherwise, it may not be concluded that the supply of goods in Slovakia was performed by the foreign person.

Given this, the Supreme Court cancelled the ruling of the regional court and returned the case to the regional court for further deliberation.

### *Practical considerations*

We believe that this decision of the Supreme Court may also be supportive for cases of import VAT deduction when the import procedure is performed by a taxable person who does not have the imported goods in his/her ownership. In practice, we have seen cases where the Slovak tax authorities conditioned the import VAT deduction on proofs that the imported goods were in the ownership of the taxable person acting as the importer.

In its decision, the Supreme Court ruled that import of goods is a specific transaction distinct from the regular supply of goods, with different attributes and a different legislative background.

If you are interested in this issue, please contact the author of this article or your manager or partner at Ernst & Young.



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## The EU Council formally adopted the Implementing Measures Regulation

In our last Tax News, we informed you that the Council of the European Union had reached political agreement on the proposed recast of Council Regulation No. 1777/2005 on implementing measures concerning the EU VAT Directive ("Regulation").

The EU Council formally adopted the Regulation at its meeting on 15 March 2011. The final version contains only formal changes on the previous version dated 2 December 2010, on the basis of which the EU Council reached political agreement on 18 January 2011.

The final version of the Regulation - Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures

for Directive 2006/112/EC on the common system of value added tax - which is effective from 1 July 2011, was published in the Official Journal of the European Union on 23 March 2011.

If you would like more detailed information regarding this issue, please contact the author of the article or your partner or manager at Ernst & Young.



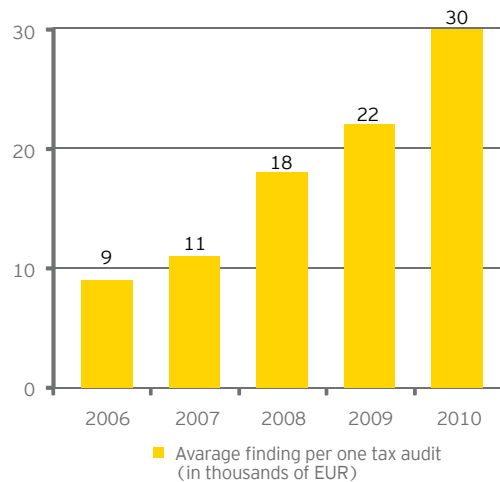
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## Tax Authorities - Results of 2010 tax audits

We would like to share with you some recent statistics on tax audits performed by the Slovak tax authorities in 2010.

There is a clear increasing trend in the value of findings. Average findings per tax audit increased by 36 % on the prior year, up to a level of more than EUR 30,000.

### Trend of average finding per tax audit in 2006 - 2010

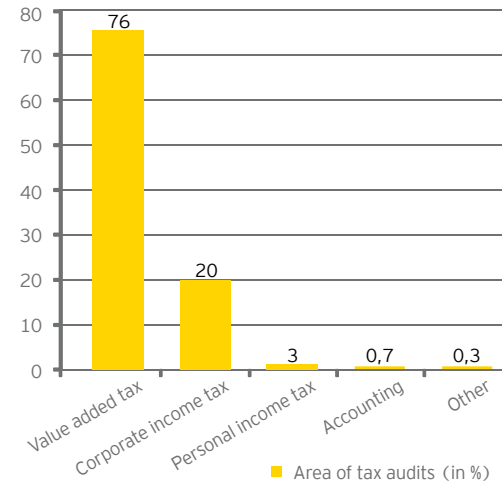


Source: Tax Directorate of the Slovak Republic

The effectiveness of tax audits was slightly more than 50%, meaning that every second tax audit resulted in a finding and subsequent tax assessment.

The findings from tax audits were predominantly in the area of value added tax. Other areas, mainly represented by corporate income tax, amounted to only approximately a quarter of the total number of findings.

### Areas of tax audits (in % of findings)



Source: Tax Directorate of the Slovak Republic

In line with the aims determined for 2010, the audits were largely focused on economically and personally related taxpayers, verification of actual performance of economic activities, intracommunity transactions, use of electronic cash registers, taxpayers providing rental services for immovable property and control of illegal work in specific economic sectors.

If you have any questions on the tax audits, please do not hesitate to contact your tax advisor in Ernst & Young or Michaela Michalovičová.

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