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Tax services

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Obsolete inventory - Ruling of the Slovak Constitutional Court

We wish to inform you of the recent development in respect of the decisions of the Slovak Supreme Court denying tax deductibility in the event of liquidation of obsolete inventory. Please refer to our September and December 2010 Tax News for details of these cases (3 Sžf 15/2009 - "Inventory I"; 5 Sžf 123/2009 - "Inventory II").

Development

The taxpayer affected by the above decisions of the Supreme Court filed a complaint with the Constitutional Court claiming that his right to an unbiased and independent judiciary, right to property and right to judicial protection had been violated.

The Slovak Constitutional Court rejected the complaint as unsubstantiated. The Constitutional Court, in particular, did not find any issues relating to the possibility of violation of constitutional rights.

In the opinion of the Constitutional Court, the Slovak Supreme Court dealt with all the relevant questions and objections raised by the taxpayer during the proceedings, summarized all the facts and logical considerations required for the proper judgment and provided clear reasons for its conclusions.

Outcome

The Constitutional Court's unfavourable ruling creates even greater uncertainty regarding the tax treatment of obsolete inventory and the overall application of the tax deductibility test in day-to-day regular business transactions.

After reviewing the development of this case, it is clear that there is a critical need for due explanatory documentation in order to apply the general tax deductibility test successfully.

As the taxpayer has now used all the domestic remedies available, it is entitled to bring the case before the European Court of Human Rights in Strasbourg. We will monitor this situation and inform you of any further progress in this respect.

If you are interested in more information or have any questions regarding the above, please contact the author of the article or your partner or manager at Ernst & Young.



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Permanent establishment - Guideline of the Slovak Tax Directorate

The Slovak Tax Directorate recently published a Guideline seeking to unify the approach of the Slovak tax authorities dealing with situations as to when a "fixed place" permanent establishment of a foreign entity could be created within the territory of Slovakia.

The wording of the guideline is generally based on and follows the respective provisions of the OECD Model Tax Convention on Income and on Capital and the Commentary thereon.

In particular, the Guideline deals with the relation between international treaties and domestic legislation, and with the conditions for the creation of a "fixed place" permanent establishment under the provisions of the Income Tax Act and the OECD Model Tax Convention on Income and on Capital.

In addition, the Guideline provides guidance on several practical situations such as:

- ▶ A German company established a repair facility in the territory of Slovakia in order to perform repairs on products sold by the company to its Slovak customers;
- ▶ A British company registered its Slovak branch for the sole purpose of obtaining a licence to conduct business in energies in Slovakia;
- ▶ A US company established a Slovak office in order to check the quality of its products prior to their delivery to Slovak customers.

We believe that the Guideline could have a positive impact, as it should serve as a universal interpretation basis for tax authorities dealing with the presence of foreign entities within the territory of Slovakia.

If you are interested in more information or have any questions regarding the above, please contact the author of the article or your partner or manager at Ernst & Young.



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OECD proposes clarifications on the meaning of 'Beneficial Owner' in the OECD Model Tax Convention

The OECD released a public discussion draft of proposed changes to the Commentary on Articles 10 (Dividends), 11 (Interest), and 12 (Royalties) of the OECD Model Tax Convention, focusing on clarification of the meaning of „beneficial owner“ (the „Discussion Draft“). The OECD Model Tax Convention and its Commentary influence the ways in which many countries interpret their income tax treaties, so any such clarification may have widespread effects.

The concept of „beneficial owner“ found in the OECD Model Tax Convention is used to determine whether the recipient of a payment is entitled to treaty benefits in respect of the payment (as opposed to being a mere agent, nominee, etc.), and has given rise to different interpretations on the part of courts and tax administrations.

Background

The introduction of the term „beneficial owner“ in the Model Treaty was primarily to counter treaty-shopping. The term is not used in a narrow technical sense; rather, it should be understood within its context and in the context of the object and purpose of the Model Treaty. However, the

current commentary does not clarify whether the term „beneficial owner“ should be interpreted in accordance with domestic law or whether the term has an international tax treaty meaning.

Contents of the Public Discussion Draft

The Discussion Draft seeks to expand the Model Treaty's commentary to provide further guidance regarding the meaning of the term „beneficial owner“ in the treaty context. The OECD believes that this guidance is necessary due to the confusion that has arisen over the term because the rules of treaty interpretation permit source countries to use domestic law in defining those terms not otherwise defined in a treaty.

In particular, the Discussion Draft proposes to clarify the „beneficial owner“ concept in the context of the Model Treaty by adding identical language to the Model Treaty's commentary on Articles 10, 11, and 12. Under the proposed clarification, it is explicit that the term „beneficial owner“ should be understood in its treaty context (namely, avoiding double taxation and the prevention of fiscal evasion and avoidance) and in relation to the words „paid ... to a resident.“

The Discussion Draft's clarification further provides that the recipient of a dividend, interest, or royalty payment is the „beneficial owner“ of the subject payment where he has the full right to use and enjoy the dividend, interest, or royalty unconstrained by a contractual or legal obligation to pass the payment received to another person. The proposed commentary

notes that such an obligation will normally derive from the relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not exercise the full right to use and enjoy the payment. Additionally, the clarification notes that, in determining the „beneficial owner“, the use and enjoyment of a payment must be distinguished from the legal ownership, as well as the use and enjoyment of the property which generated the payment.

Implications

The Discussion Draft's proposed clarification represents a step towards achieving an international consensus on the scope and meaning of the term „beneficial owner.“ This step appears to be in tacit agreement with the UK Court of Appeal's decision in *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA* („Indofood“) that the term should be interpreted as a global concept and „be given an international fiscal meaning not derived from the domestic laws of contracting States.“

Given the effect these changes could have on treaty interpretations by member countries of the OECD, taxpayers should closely review the discussion draft and consider whether it would be appropriate to provide comments on the proposed additions.

The public discussion closes on 15 July 2011 and the Working Party should examine the comments at the September 2011 meeting. We will inform you of future developments in this respect.

Given that the Slovak tax legislation does not currently include a definition of “beneficial owner”, it is probable that the Slovak tax authorities will follow the “full use and enjoyment” principle outlined in the Discussion Draft, once it is implemented by the OECD. Practical examples where “beneficial ownership” could be an

issue are so-called back-to-back or central procurement arrangements where the role of a contractual party is more that of a cash transferor without adding any due value within the transaction chain.

We would be pleased to discuss with you the potential practical implications of the amendment of the OECD proposal to your company. If you have any questions, please feel free to contact Richard Panek or your contact person in our team.



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The Slovak Government approves the concept of tax and social security system reform

In our April edition of Tax News, we foresaw major technical changes in the tax and social security system on the basis of the reform proposal.

Following comments by selected institutions and public discussion, the concept of the reform was placed on the agenda of the Slovak Government session on 18 May with only slight changes. The

proposed changes concerning the social security burden of self-employed individuals and application of the flat rate 40% expenses deduction, which were criticized during public consultation, remained unchanged in the reform concept.

At the session, the Slovak Government approved the concept of the reform with certain adjustments, hence the legislative process moves on to its next stages where the proposed amendments should pass through the interdepartmental comments procedure, the Slovak Government session and three readings in the Slovak Parliament.

In the Resolution of the Slovak Government, the amendments covering the technical changes in the system, including introduction of the new gross employees’ remuneration at the level of “super-gross salaries”, should be prepared for the Government session by 17 August 2011 at the latest. The changes proposed in the reform should enter into effect from 1 January 2012.

We will inform you of further developments in this area.



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Amendment to the Health Insurance Act

The amendment to the Health Insurance Act was approved in April 2011 and is effective from 1 May 2011. The main changes introduced by the amendment are as follows:

The obligation to perform an annual health insurance reconciliation is transferred from the employer and self-employed persons to the Health Insurance

Agencies, with effect from 2011 (health insurance reconciliation to be performed in 2012).

In this respect, the reporting obligations on the employer as well as on self-employed persons are amended. In the monthly health insurance report, the employer is required to declare the actual amounts of income provided to the employee in that month. If the employer employs more than three employees, the monthly report is to be filed electronically.

The Health Insurance Authority is entitled to request the employer (or self-employed person) for the documents needed for calculation of the health insurance prepayments and the annual reconciliation.

If the employer does not provide the documents needed for calculation of the health insurance prepayments to the Health Insurance Agency, the Health Insurance Agency is entitled to calculate the prepayments on the basis of the average salary in the Slovak economy.

If an individual is not subject to the annual health insurance reconciliation because he/she was subject to health insurance abroad over a part of the year, he/she is obliged to substantiate the period of foreign health insurance cover to the Health Insurance Agency. The confirmation must be provided by 31 March of the following year.

The amendment rescinds some controversial provisions effective from 1 January 2011. Specifically, income from the rental of immovable properties is not to be subject to health insurance. In addition, students are to be treated as dependent children (health insurance to be paid by state) up to thirty years of age.



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General assessment base for social security purposes

The Ministry for Labor, Social Affairs and the Family has released details of the 2010 general assessment base for social security purposes. This amounts to EUR 9,228 and will have an impact on the calculation of some social security contributions in 2011.



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Proposed Amendment to the Slovak Labor Code

The Slovak Government recently submitted its proposed Amendment to the Slovak Labor Code to the Slovak Parliament. The proposed changes should, inter alia, introduce more flexible working arrangements and reduce certain excessive employers' costs, thus providing better grounds for the creation of new posts. The proposed changes also concern the position of unions and other labour law areas.

We summarize some of the proposed changes below:

- ▶ Differentiated probationary period (the standard three-months probationary period can be extended up to six months for certain managerial positions);
- ▶ Reduction of standard notice period to one month (the standard notice period should then increase proportionally to the length of employment);
- ▶ The option to combine notice period and severance pay (if the employee continues to work for the

employer during a part of the notice period, he/she is entitled to a proportional severance payment for the remainder of the notice period);

- ▶ Anchoring non-competition rules covering the period of employment and, in certain circumstances, also for a period of up to one year after termination of the employment (non-competition agreements are already common in practice; however they lacked clear legal grounds within the Slovak Labor Code);

- ▶ Option to deliver paylips by electronic means, if agreed with the employee;
- ▶ Option to agree fully flexible working hours;
- ▶ Introduction of so-called “shared work position” (two or more part-time employees share the same position, based on their agreement).

Should this amendment be adopted, the changes will become effective on 1 September 2011.

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



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Draft conception on combating tax evasion in the area of employment tax

The Slovak Ministry of Finance issued another document presenting measures against tax evasion. This document pursues the area of tax from employment activities and was approved by the Slovak Government on 4 May 2011.

As was the case with the suggestions dealing with VAT and excise duties (please refer to Tax News 02/2011) this document also identifies the most common forms of tax evasion, estimates the volume and suggests specific measures of a legislative and non-legislative nature to combat tax evasion in the area of employment tax.

The most common methods of tax evasion in the area of employment tax identified and outlined in the document include employing persons without labour contracts, cash payments in higher amounts than

agreed in the employment contracts, reclassification of employment activities to independent activities (the so-called Schwarz system), etc.

The document suggests several methods for combating tax evasion; for instance the following:

- ▶ Establishment of a Registry of tax inspections executed with the aim of developing a quality system for the selection of subjects for tax inspections;
- ▶ Greater cooperation of the tax authorities with labour control authorities and external connections with other authorities (Commercial Register, Agency of Labour, Social Issues and the Family, Social Authority, health insurance agencies);
- ▶ Unification of collection of taxes and social security contributions (UNITAS);
- ▶ Regular monitoring of new (not yet documented) forms of tax optimization in the area of income tax.

Implications for businesses

As the suggested rules are aimed at combating tax evasion, some of them may hamper the position of taxpayers or impose additional administrative burdens. The degree of interference with the current practice depends on the selection of measures to enact, and the manner in which they will be implemented and enforced with taxpayers.

This document represents only a number of ideas on how to combat tax evasion in future and does not constitute any legally binding rules. We will monitor whether any of the rules are pursued further with potential implementation into the legislation.



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Supplies of gas, electricity, heat and cold - guideline of the Slovak Tax Directorate

The Slovak Tax Directorate recently published on its web page a Guideline to Act No. 222/2004 Coll. (Act on VAT) with regard to supplies of gas, electricity, heat and cold.

The Tax Directorate Guideline summarizes the VAT treatment of these supplies, from introduction of

the rules in 2005. It also deals with current issues consequent on the amendment to the VAT Act effective from 1 January 2011. These issues include a discussion on designation of the place of supply, liability for tax, the appropriate treatment for exports and imports, and the role of the Fixed Establishment of the supplier / customer in interpretation of these rules.

The Guideline also deals with the VAT treatment of services for access, transport and distribution of energy, and with other changes related to

implementation of Directive 2009/162/EC into the VAT Act from 1 January 2011.

We would be pleased to discuss with you any questions you might have in this respect. Please contact the author of this article or your usual partner or manager at Ernst & Young.



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Guidance of the Slovak Tax Directorate on the place of supply of services in accordance with Article 16 (3) of the Slovak VAT Act

Amendments to the VAT Act in 2010 and 2011 introduced significant changes in the rules for the determination of the place of supply of services. Thus, with effect from 1 January 2011, the place of supply of cultural, artistic, sporting, scientific, educational, entertainment or similar events such as fairs and exhibitions, and of ancillary services supplied to a taxable person, is, as a general rule, in the country of the customer. However, an exception to this rule was

introduced as of 1 January 2011 - services related to admission to the events have their place of supply in the country where the event actually takes place.

In practice, problems have arisen in determining what are deemed to be services in respect of admission to cultural, artistic, sporting, scientific, educational, entertainment or similar events. Hence, the Tax Directorate recently issued the Guidance in which it clarifies the main attributes of these services.

According to the Guidance, services in respect of admission to the events are deemed to be those services where the granting of the right of admission to the event is exchanged for a ticket or payment, including a season ticket or repeat fee or subscription, in particular the following services:

- ▶ The right to admission to shows, theatrical performances, circus performances, fairs, amusement parks, concerts, exhibitions and other similar cultural events;
- ▶ The right to admission to sporting events such as matches and competitions;
- ▶ The right to admission to educational and scientific events such as conferences and seminars.

We wish to note that this definition of services in respect of admission to cultural, artistic, sporting, scientific, educational, entertainment or similar events is in accordance with the definition included in the amended VAT Regulation which enters into effect from 1 July 2011.



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Amendment to the VAT Act effective from 1 January 2011 - Guideline of the Slovak Tax Directorate

The Slovak Tax Directorate recently published on its website a Guideline to Act No. 490/2010 by which the Value Added Tax Act (VAT Act) was amended with effect from 1 January 2011.

The amendment to the VAT Act was primarily driven by the need to transpose several EU Council Directives into the national legislation, dealing with the place of supply of services, prevention of tax evasion upon import of goods, VAT treatment of heat, cooling energy, etc. Other provisions of the VAT Act were amended with a view to increasing legal surety.

The Tax Directorate Guideline addresses selected changes to the VAT Act, as follows:

Tax point of goods / services supplied on partial or recurrent basis

- ▶ from 1 January 2011, arising at the latest on the last day of the period to which the payment relates, i.e. taxpayers may once more opt for a tax point earlier than the last day of the respective period (which led to application problems in practice in 2010);
- ▶ the tax point may be determined for a date earlier than the period to which the payment relates;
- ▶ if a payment is received in advance, VAT becomes chargeable on the date of receipt of the payment.

VAT rates

- ▶ standard VAT rate increased to 20% with temporary effect until the fiscal deficit drops below 3%;
- ▶ any tax base corrections relating to supplies with 19% VAT rate - 19% VAT rate to be used.

VAT exemption upon importation of goods

- ▶ the conditions under which the importation of goods into Slovakia, while the goods are designated as supplies to other EU Member States, can be treated as VAT-exempt were inserted into the wording of Article 48 (3) of the VAT Act;
- ▶ the importer, or an import VAT representative, must provide the customs authorities at the time of importation with:
 - ▶ VAT identification number in Slovakia: VAT certificate to be provided;
 - ▶ VAT identification number in another EU Member State (designation of goods): VAT number of the customer or importer (transfer of own goods);
 - ▶ proof that the goods are to be transferred from Slovakia: transfer agreement, transportation document.

VAT deduction and exempt supplies

- ▶ VAT payer cannot deduct VAT in respect of the receipt of supplies of goods and services to be used for exempt supplies in accordance with Article 42 of the VAT Act (i.e. goods and services used for exempt supplies; goods and services with blocked VAT deduction).

VAT refunds to foreign persons from third countries

- ▶ one agent may represent not only one but multiple VAT payers in the procedure of requesting a VAT refund on behalf of a foreign person from a third country.

Persons liable for VAT

- ▶ services and goods with installation/assembly supplied by a foreign person to a Slovak VAT-established person, while the place of supply is in Slovakia - subject to reverse-charge mechanism; the recipient is liable for the tax irrespective of

whether the foreign person is registered for VAT purposes in Slovakia;

- ▶ the recipient is also liable to pay VAT in cases where the supply is performed by a foreign person having a VAT establishment in Slovakia, when the said VAT establishment plays no part in the supply.

Local reverse-charge on supplies of greenhouse emissions

- ▶ A VAT payer acquiring greenhouse gas emissions with the place of supply in Slovakia from another Slovak VAT payer is liable for VAT on the transaction.

We would be pleased to discuss with you any questions you might have in this respect. Please contact the author of this article or your usual partner or manager at Ernst & Young.



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Interest payable by the Tax Authority on excess VAT refunded after the statutory deadline

The Court of Justice of the European Union ("CJEU") recently published its decision in Case C-107/10 Enel Maritsa Iztok 3 AD ("Enel") concerning the period for which default interest is due to the taxpayer in the event of refund of excess VAT delayed due to tax investigation.

Situation

In the case in question, Enel submitted a VAT return resulting in a VAT overpayment, which should normally have been refunded within 45 days of submission of the VAT return. Under the Bulgarian legislation, the Tax Authorities are under an obligation to pay default interest if they delayed the refund of the excess VAT.

During the 45-day period, the Tax Authorities initiated a tax investigation, resulting in an extension of the excess VAT refund period up to the end of the investigation. As the Bulgarian Authorities were delayed in refunding the excess VAT overpayment to Enel, even beyond the time at which the tax audit finished, they awarded default interest to Enel. They insisted that the default interest accrued from the end of the tax inspection (i.e. the date when the tax audit report was issued) up to the date of the actual VAT repayment to Enel.

Enel disputed this and brought an action before the Bulgarian court claiming interest for the period from the date when the original deadline for VAT refund lapsed up to the date of the actual repayment of VAT. The issue was referred to the CJEU seeking clarification, inter alia, as to whether (i) the excess VAT refund period may be extended in order to perform a tax audit and, if so, (ii) whether the interest payable on the delayed refund of excess VAT accrues only from the date when the tax audit ends.

Decision of the CJEU

In its decision, the CJEU stated that the right to deduct is an integral part of the VAT scheme and it may not be limited. While the Member State enjoys a certain freedom in determining the conditions for the refund of excess VAT, those conditions may not undermine the principle of fiscal neutrality by making the taxable person bear the burden of the VAT, whether in whole or in part. On the other hand, the CJEU observed that Member States may take all appropriate legislative and administrative measures to ensure accurate VAT collection. It concluded that the period for refunding excess VAT may be extended for a **necessary period** in order to carry out a tax audit inspecting the tax payer's right to excess VAT deduction.

As regards the interest, the CJEU observed that delay in payment of the VAT refund due to initiation of the tax audit represents a situation in which the taxpayer is temporarily deprived of its funds. This is an economic disadvantage and the taxpayer should be compensated by payment of default interest. The interest should begin to accrue as of the expiry of the normal period for refunding excess VAT, in the light of the principle of fiscal neutrality.

Practical considerations

It appears that this ruling could have substantial consequences on how the Slovak tax authorities interpret the default interest in practice. In the light of the court analysis, Slovak taxpayers could claim default interest for repayments of excess VAT made after the VAT investigation is finished but accruing from the date of expiry of the statutory VAT refund period (currently two months from submission of the VAT return). In our opinion, there are grounds for claiming this right, not only for future instances but also for similar situations occurring in the past.

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

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The information in this newsletter is correct to the best of our knowledge and belief at the time of going to press. Specific advice should be sought before investment and other decisions are made.

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