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Substantiating whether the conditions for tax deductibility of expenses have been fulfilled - Slovak Supreme Court judgment

The Slovak Supreme Court ("Court") recently published its judgment (8 Sžf 2/2010) regarding substantiating whether the conditions for tax deductibility of expenses have been fulfilled.

Decision

In its ruling, the Court stated that a taxpayer declaring the receipt of goods solely through the respective invoice is not sufficient to fulfill the legal conditions for the tax deductibility of expenses and the subsequent determination of the correct amount

of the tax base. The taxpayer must be able to provide tax documentation that can unequivocally prove the receipt of the taxable supply as well as the fact that the supply stated in the tax document has actually taken place.

Although extensive evidence was gathered during the tax proceeding, according to the Court the evidence was not properly focused on the subject-matter of the dispute. Rather, it was concentrated on proving the way, how the supplier of the taxpayer acquired the goods (e.g., through drivers' names, number plates) instead of substantiating whether the actual supply of goods between the supplier and the taxpayer was carried out. As a result, the Court returned the case to the tax authorities for further processing and collection of evidence.

Practical implications

Taxpayers should be aware that the tax authorities are increasingly taking the substance of transactions into consideration rather than relying on formal evidence; although in some cases they tend to drift away from the subject-matter of the dispute. Therefore, for the deductibility purposes, taxpayers should be able to substantiate that supplies actually took place. At the same time, the evidence should be performed mainly on the side of a taxpayer rather than of its supplier.

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



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Proposal of the act on adjustment of the income from dependent activities (implementation of the Tax and Social security reform)

In our April edition of Tax news we informed you about the changes to be introduced by the tax and social security reform, which should be applicable from the beginning of 2012.

Now that they have been approved by the Government, the changes have been transformed into amendments of the respective legislation. Besides

the Act on the Adjustment of Income from Dependent Activities ("the Super-gross salary Act") which introduces the "super-gross salary" and determines the rules of how this is applied, the reform indirectly amends more than 100 other acts, including the Act on Social Security, the Health Insurance Act, the Income Tax Act, the Act on Tax Administration, the Criminal Act, the Labour Code and the Travel Allowances Act to name but a few.

The Slovak Government approved the amendments to the Super-gross salary Act and the indirect amendments to other legislation on 19 August 2011 and subsequently passed them to the Slovak Parliament.

► Proposal of the Super-gross salary Act

One of the cornerstones of the reform is the introduction of the new, higher salary, so called "super-gross salary". This means the remuneration that equals the sum of the current gross income increased by the employer's part of social security and health insurance ("SSHI") contributions. At the same time, the employer's part of the SSHI contributions (with the exception of accidental insurance) will be abolished.

The new gross salaries will not be only theoretical for tax and SSHI purposes (as the "Czech model") but will represent an actual increase in employees' gross salaries. The proposed wording of the Super-

gross salary Act describes how the employer should approach the process of calculating the super-gross salary.

The key task for EACH employer will be to compute the correct increased gross (super-gross) salary for EVERY employee.

In this respect, it is crucial to determine the proper tax and SSHI regime of every compensation item that the employer provides (i.e., differentiate between taxable and non-taxable income and reflect the income that exceeds the maximum assessment basis for social security and health insurance purposes etc.). Significant issues may also arise in calculating the super-gross salary on benefits in kind, bonuses and stock option plans; or in other words income whose value can be determined at the date on which it is paid but not on 31 December 2011.

According to the Super-gross salary Act, employers will be obliged to amend all employment contracts, collective employment agreements, internal guidelines and other contracts/documents touching its employees' remuneration by 31 January 2012.

Ensuring that employers comply with the proposed legislation will be the responsibility of the Labour Inspectors, as well as the Tax Authorities during tax inspections. The proposed legislation introduces strict sanctions in cases of the non-compliance with the Super-gross salary Act (incorrect calculation of the new salary harming the employees). Penalties will range from 10 to 100 times the difference between the amount of the "super-gross" salary and the unadjusted remuneration (on the employee-by-employee basis and for the whole period reviewed).

On the other hand, should employers decide to apply a conservative approach to increasing employees' income (in favour of employees; without reflecting the tax regime of the particular income items or the social security caps), the overall effect would be an increase in the employer's labour costs.

Given the scale and complexity of the proposed changes, adjusting salaries will bring very significant one-off administrative burdens for all Slovak employers.

Therefore, we recommend that employers start preparing to implement the changes well ahead of January 2012 so that they have sufficient time to resolve possible issues as well as to identify certain optimization options.

► *Proposal of the indirect amendment to the Income Tax Act*

We mentioned the main amendments to the Income Tax Act in our April 2011 Tax news. These include non-deduction of the social security and health insurance contributions from the tax base of individuals, the abolition of the "millionaire tax", flexible tax depreciation of tangible assets for self-employed individuals and limitation of the 40% flat deduction up to EUR 200 per month).

We would like to draw your attention to the proposed change regarding determining the personal income tax base.

According to the proposal, the personal income tax base should include social security and health insurance contributions (i.e., it will not be decreased by the employees' social security and health insurance contributions). Considering changes to the social security insurance contributions rates, this change should not (negatively) affect the majority of Slovak employees.

However, it may negatively affect some groups of employees, such as foreign individuals working in Slovakia who contribute to their domestic social security and health insurance systems.

According to the proposal, these employees will not be entitled to decrease their tax base by the employees' foreign social security contributions (while their gross salary will not be increased as in the case of Slovak employees). In addition, the employer part of their foreign social security

contributions will be added to their employment income for the purpose of calculating their Slovak personal income tax base.

In this scenario, we recommend considering the financial impact of the new law on the net income of affected employees and on the employer's financial burden in the case of "tax equalised" assignees.

► *Proposal to indirectly amend the Act on Health Insurance and the Social Security Act*

We explained the proposal to amend the Act on Health Insurance and the Social Security Act in our April 2011 Tax news. In particular, it concerns the cancellation of the employer's contributions (except for accidental insurance), the unification and change of the contribution rates, the introduction of a single maximum contribution instead of several maximum assessment bases, the introduction of the annual reconciliation of the social security contributions and the removal of the fund management of the Social Security Agency.

The contributions to the old-age pension fund ("third pillar") will no longer be included in the assessment base either for social security or health insurance.

The Proposal also introduces a deductible item from the assessment base of individuals who perform activities based on agreements other than standard employment agreements (agreement on performing a certain task etc.) amounting to EUR 190 per month.

It also includes some other changes in the area of social security and health insurance that will be described in more detail in future editions of Tax news (once the amendment has been approved by the Slovak Parliament).

► *Proposal on the indirect amendment of other concerned legislation*

As already mentioned, the proposed act will indirectly amend the Criminal Act. Not paying social security

and health insurance contributions (except for accident insurance contributions) and contributions to the old-age pension fund will be considered a criminal offence.

The proposed the **Super-gross salary Act** indirectly amends many other acts; mainly relating to the

mathematical computations of the “super-gross” salaries for various types of individuals.

We will keep monitoring the legislative process surrounding the new legislation and will keep you informed of any developments.

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



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Proposed Amendment to the Income Tax Act

The proposed Act on the amendment of income from dependent activities (“the Proposal”) will also modify the Income Tax Act in the area of corporate and individual taxation. The Proposal, which received Government approval on 19 August 2011, will now be discussed by Parliament. Further modifications may be adopted during the parliamentary proceedings.

In the following section, we provide an overview of the main changes to corporate income tax that are included in the Government approved version.

a) Financial lease

- ▶ Unifying the depreciation of tangible assets acquired through financial leases with assets acquired in other ways has again been proposed (a similar proposal was submitted last year but was not passed). Tangible assets acquired through financial leases are to be depreciated over the regular period stipulated by the ITA, rather than over the period of the lease.
- ▶ The draft amendment introduces specific provisions covering adjustments to the tax base in the event of:
 - ▶ A breach of the conditions of the financial lease
 - ▶ Purchasing a leased asset for less than the net book value of the asset

These provisions should apply to tangible assets acquired under financial lease agreements concluded after 31 December 2011. In line with the proposed transitory provisions of the ITA, existing financial lease agreements should continue to be governed by the current rules.

Provided that due commercial reasons apply, taxpayers may consider acquiring assets through financial leases prior to the year-end, so as to benefit from the accelerated tax depreciation.

b) Depreciation of tangible assets

- ▶ Tax depreciation charges will no longer apply in the full yearly amount for tangible assets acquired during the tax year. The draft amendment introduces proportional tax depreciation charges starting in the month in which the asset is put into use. This should apply to tangible assets put into use after 31 December 2011.
- ▶ Under the proposed amendment, individual entrepreneurs will be allowed to depreciate tangible assets acquired after 31 December 2011 in the tax period of their choice and at the amount of their choice (up to the acquisition price), subject to the condition that the asset must be included in business assets over the whole regular depreciation period stipulated by the ITA.

c) Carry forward of tax losses generated by individuals

- ▶ Only tax losses generated from business income and income from independent activities will be able to be carried forward. The Proposal puts an end to the possibility of carrying forward tax losses generated by individuals from capital income and other income.

d) Changes proposed in connection with the introduction of “supergross” salary

The proposed amendment specifically stipulates that mandatory social security and health insurance contributions will not be tax deductible expenses for employers and individuals generating business income or income from independent activities. Only the mandatory employer’s contributions to accident insurance will remain tax deductible expenses.

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



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Slovak Supreme Court Decision (3 Sžf 1/2011)

The Slovak Supreme Court issued its decision regarding the burden of proof in situations in which a tax authority questions the VAT payer's deduction of input VAT.

Situation

The Slovak VAT payer deducted input VAT on goods and services it purchased. During a tax audit, the tax authority challenged the deduction on the basis that the VAT payer did not adequately prove that the goods and services were acquired from a particular supplier. The tax authority argued, inter alia, that the supplier of the claimant did not present the requested accounting documents, nor any proof that it performed the taxable transactions.

On the other hand, the tax authority did not question in any way that the goods and services were actually supplied to the VAT payer.

The VAT payer appealed against the decision, claiming that all statutory conditions for the VAT deduction were met and that it had provided the tax authority with all available evidence proving that the supplies were made (including invoices containing the detailed list of the goods and services supplied).

Decision

The case was brought before the Supreme Court, which ruled in favor of the VAT payer. In its reasoning, it stated that the deduction of the input VAT by the VAT payer cannot be made conditional on the VAT payer being able to demonstrate facts which should be proved by other parties to the transaction. In other words, the VAT payer should not be required to demonstrate facts concerning the relationship between the supplier and its subcontractors.

The Supreme Court also concluded that in a situation in which the VAT payer demonstrates the existence of the supply using invoices containing detailed lists of the goods or services supplied, the tax authority must

bear the burden of proof in proving the opposite.

In the reasoning, the Supreme Court also referred to the decision of Court of Justice of the European Union in joined cases C-354/03 (Optigen), C-355/03 (Fulcrum Elektronics) and C-484/03 (Bond House) in which the Court held that the right to deduct input VAT cannot be affected by the fact that a prior or subsequent transaction in the chain of supply is vitiated by VAT fraud, if the taxable person does not know, or has no means of knowing about it.

Practical consequences

This Supreme Court ruling strengthens the position of taxpayers in tax proceedings, as it clarifies who the burden of proof lies with (taxpayers and the tax authorities).

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Tax Directorate information on the application of Implementing Regulation for the EU VAT Directive

In our previous Tax news, we informed you about Council Implementing Regulation No. 282/2011, which lays down implementing measures for the EU VAT Directive ("Regulation") that entered into force

on 1 July 2011. The Slovak Tax Directorate published Information on how the Regulation should be applied.

The Information summarizes the most important provisions in the Regulation in terms of respective Articles of the Slovak VAT Act. It also provides some practical examples in this respect.

Among other things, the Tax Directorate emphasizes that if there are any inconsistencies, the Regulation prevails over the Slovak VAT Act. For example, a taxable person registered for Slovak VAT purposes

in accordance with Article 7a of the Slovak VAT Act is entitled to non-taxation of its intra-Community acquisition of goods not exceeding EUR 13,941.45 even the Slovak VAT Act directly does not directly recognize this.

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CJEU judgment in C-464/10 Belgian State vs Henfling, Davin, Tanghe - Exemption of betting services if supplied by a commission agent

On 14 July 2011, the Court of Justice of the European Union ("CJEU") published its decision in Case C-464/10 Hefling, Davin, Thanghe, concerning the refusal of the Belgian tax office to allow the exemption from VAT of betting/gaming services if supplied by a commission agent acting in its own name, but on behalf of a principal.

Situation

Tiercé Franco-Belge SA ("TFB") is a company, registered for VAT purpose in Belgium, which takes bets mostly on horse races in Belgium and other States. In the course of its business TFB uses a network of local agents ("buralistes") for collecting betters' stakes and for providing other betting related services (e.g., registering the bets, issuing betting slips and paying out winnings) based on the "commission contract" concluded.

Under this contract, TFB is the owner of the business that the "buralist" is responsible for managing and provides the "buralist" with all necessary equipment and documents to be used to record all bets made and winnings paid. The "buralist" is obliged to receive all types of bets for which TFB is fully authorized and is paid a commission for the services provided under the "commission contract".

The Belgian tax authorities refused to allow the services provided under the commission contract to be exempt from VAT, taking the view that as the "buralist" works under the TFB name, in effect, he or she provides a service to TFB. The tax authorities sent TFB a demand, increased by fines and late interest payments, for the VAT due on these services.

Argumentation of the parties

In the CJEU referral, the Belgian court sought clarification as to whether precluding an exemption from VAT for services supplied by a commission agent who acts in his or her own name, but on behalf of a principal who organizes supplies of services referred to in Article 13(B)(f) (i.e. exemption of betting, lotteries and other forms of gambling from VAT) is contrary to Article 6(4) and Article 13(B)(f) of the Sixth Directive.

The CJEU firstly referred to its previous decision (United Utilities) which held that the supply of services of accepting bets on behalf of the organizer, does not constitute a betting transaction within the meaning of Article 13(B)(f) and, thus, cannot, qualify for VAT exemption.

However, the CJEU further stated that this proceeding differs from the one mentioned above, as based on the nature of the services provided to TFB, the "buralist" clearly acts in his or her own name when collecting the bets, which means that legal relationship is brought about not directly between the better and the TFB on whose behalf the "buralist" acts, but between the "buralist" and the better, on the one hand, and between the "buralist" and TFB, on the other.

Such involvement from a VAT point of view (Article 6(4) of the Sixth Directive) provides that, where a taxable person acting in his or her own name but on behalf of another takes part in a supply of services, he is considered to have received and supplied those services himself. The concept of exemption of transactions from VAT can be applied on these notional buy-sell transactions as well. Hence, **the commission paid to a commission agent, acting in his or her own name but on behalf of another, can be exempt from VAT.**

Decision of the CJEU

The CJEU has taken the view that in order to properly assess the VAT treatment of the commission paid to commission agents when collecting bets, it is crucial to establish whether the agent acts in his or her own name when providing these services.

CJEU concluded that should an economic operator act in transaction exempt from VAT in his or her own name, but on behalf of an undertaking engaged in bet-taking, then it is to be considered to provide that operator with a supply of bets coming under that exemption.

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



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CJEU referral from Slovakia in “Profitube” case

In the March 2011 edition of Tax news we informed you about the Slovak Supreme Court ruling regarding the VAT regime in terms of sale of goods held under the customs warehousing regime. In its decision, the Supreme Court ruled that sale of goods warehoused within the territory of Slovakia and placed in the customs regime of customs warehousing cannot be subject to Slovak VAT.

We view this decision as somewhat controversial from the perspective of European VAT legislation and

taking into account its implementation in Slovak VAT legislation. For more details on the ruling, please refer to our March 2011 edition of Tax news.

The CJEU website currently shows a referral from the Slovak Supreme Court on the question of whether supply of goods in such cases should be subject to Slovak VAT. We will keep you informed on the progress of this referral.

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



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Amendment to the EU Energy Taxation Directive proposed by the European Commission

We would like to inform you that the European Commission recently presented a proposal for an amendment to the EU Energy Taxation Directive (“Amendment”), which will be applicable to the taxation of energy products and electricity.

The intention behind the amendment is to refashion and balance outdated rules applicable to the taxation of energy products and electricity in the EU. The main

change to the existing rules will be that energy taxes will be split into two components (i.e., CO₂-related taxation and general energy consumption taxation), which would determine the overall rate at which a product is taxed. The Amendment also proposes new minimum tax rates for applicable products.

If the Amendment is approved, the EU member states will be obliged to implement new minimum tax rates into national legislation by 1 January 2013. Regarding the introduction of CO₂-related taxation, it is proposed that Slovakia and several other countries be granted a transitional period until 1 January 2021.

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



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Slovak Supreme Court Judgment - Duration of tax audits

The Slovak Supreme Court ("Court") recently published its judgment (6 Sžf 37/2010) on the implications of infringing the period in which the tax authorities can perform tax audits.

Decision

In its ruling, the Court stated that the principle of proportionality in tax proceedings is also embodied in tax audits having a limited duration. If they exceed the specified duration the tax authorities commit not only a breach of the respective provisions on the duration of tax audits, but they also breach the proportionality principle and the legality principle. Therefore, protocols derived from any such tax audit should be considered to be unlawfully acquired evidence, the

use of which, in any further tax proceedings leading to the assessment of additional tax, will mean that the proceeding in question is illegal.

The Court also pointed out that restricting the extensive duration of the tax audit should be applied only if the taxpayer cooperates with the tax authorities that are conducting the tax audit. In other words, if the taxpayer does not fulfill the obligation to cooperate with the tax authority in the course of the tax audit, it cannot benefit from the stipulated deadline for ending the tax audit.

Practical implications

This ruling means that the Court further shifts the interpretation of the adequacy principle and the legality principle during tax audits and tax proceedings. However, it should be noted that the benefit of this interpretation is available only to those

taxpayers who fulfill their legal obligations (e.g. provide all requested information) in the context of any tax audit.

Based on the new Act on Tax Administration effective from 2012, the duration of tax audits initiated after 2011 is not limited by specific dates. In this context, it will be interesting to see how courts interpret the principles of proportionality and legality with respect to tax audits performed in the future.

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Proposal on measures to improve the provision of tax information by the Slovak tax and customs administration

We would like to inform you of the proposal on measures to improve the provision of tax information by the Slovak tax and customs administration ("Proposal"), which was recently approved by the Slovak Government.

The Proposal focuses on the following areas:

1) Unified system for providing tax information

- ▶ Uniform procedures for provision of information

- ▶ Regular publishing and updating of generalized information
- ▶ Call centre for straightforward requests;

2) Strengthened cooperation with professional chambers, unions and associations

- ▶ Regular meetings and issuance of guidance based on the conclusions
- ▶ Access to the website of tax administration where the professional chambers, unions and associations can communicate problematic issues and suggest solutions;

3) Annual survey to measure satisfaction with the services provided

4) Introduction of binding opinions effective from 1 January 2013

- ▶ For more information on the potential implications relating to the binding opinions, please refer to our June Tax News issue.

The Slovak Ministry of Finance will prepare and submit an amendment of the Tax Administration Act and other related Acts to the Government by 30 June 2012. We will keep you updated on the legislative process of the proposals.

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Abolition of the crude oil duty

We would like to briefly inform you about a recent change to the duty applicable to crude oil imported to Slovakia from the EU and third countries.

Although the crude oil duty was introduced only recently (it came into effect on 1 January 2011), it has been abolished by the Amendment to the Act on the Public Authorities Responsible for the Customs Administration No. 256/2011 Coll. ("Amendment"). The Amendment will come into force on 1 September 2011.

Further changes introduced by this Amendment include a slight increase in fees on the import of selected oil products and the Customs Office becoming responsible for collecting these fees.

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

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