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Slovak Supreme Court judgments on tax deductibility of salaries and burden of proof

The Slovak Supreme Court (“the Court”) has published its judgments (4 Sžf 7/2011 and 4 Sžf 11/2011) dealing with the burden of proof in situations in which the tax authority challenges the tax deductibility of costs.

Situation

The tax authority performed a tax audit on a taxpayer and challenged the tax deductibility of the salary costs incurred for an accountant, cleaner, driver and hairdresser employed by the taxpayer.

The tax authority argued, inter alia, that the taxpayer had failed to prove that the respective costs met the general tax deductibility test.

Furthermore, the tax authority claimed that the taxpayer did not account for any revenues directly attributable to the activities performed by the employees.

The taxpayer appealed against the decisions of the tax authority, claiming that all the statutory conditions for the deductibility of costs were met.

Decision

The case came before the Supreme Court, which ruled in favour of the taxpayer. In its reasoning, the Court stated that the responsibility lies with the tax authority to prove that costs were not incurred by the taxpayer in order to generate, maintain or assure taxable income.

The Court concluded that, if a taxpayer proves that business related costs were actually incurred, the tax authority must prove by means of clear and consistent evidence that the costs do not meet the general tax deductibility test.

In addition, the Court ruled that the absence of revenues related to the respective costs is not a due basis to conclude that the costs are tax non-deductible.

In its decisions, the Court did not differentiate in any way between the individual types of costs incurred.

Practical implications

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

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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Tax deductibility of expenses for advisory services- Judgment of the Czech Supreme Administrative Court

We wish to inform you of a recent case dealing with the tax deductibility of expenses incurred by a company on advisory services provided by the parent company.

The case was decided by the Czech Supreme Administrative Court (“the Court”) (Judgment No. 8 Afs 19/2010 - 125).

Situation

The Czech company performed activities in the area of real estate rentals. In the course of its business activities, it incurred expenses on advisory services relating to the proposed sale of real estate. Following a change in the company’s shareholder, the

expenses on these management services increased significantly.

The Financial Authority challenged the tax deductibility of these expenses, claiming that they were not required for generating taxable income. One of the main arguments was that no sale of real estate occurred over the audited period. The fact that the services were provided by the Austrian parent company and increased significantly over the audited

period clearly did not improve the position of the Czech company in the eyes of the tax authorities.

The Czech company sought to explain that the services were necessary for its business activities as they concerned the sale of real estate. As the company did not have its own staff, all stages related to the sale had to be delegated to an external company. However, the transaction was cancelled due to the financial crisis.

Decision

The case came before the Czech Supreme Administrative Court which ultimately dismissed

the claim. The main reason was that the expenses incurred and the income generated were not adequately linked. In addition, the company was unable to sustain the burden of proof, as it was able to provide only very general documentation relating to the services rendered, without any detailed description of the activities performed.

The Czech Supreme Administrative Court stated that the expenses did not make sense from a business perspective. In the case in question, the expenses increased while the income remained almost constant over the audited period.

Practical Consequences

This case confirmed once more that taxpayers should pay close attention to (increased) expenses when they do not directly lead to any taxable gains (income). These expenses need to be properly documented and the link to potential future taxable income should be apparent.

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 Act on Accounting

We would like to inform you about a new Amendment to the Act on Accounting ("the Amendment"). The Amendment has already been discussed within the Government and will now be sent for discussion in the Government advisory committees. It will then be forwarded to the Parliament for further debate, where further modifications may be adopted. In the following section, we provide an overview of the main proposed changes to the Act on Accounting in the present version.

a) Penalties

The Amendment introduces a new system of imposing penalties for non-compliance with the Act on Accounting, which we believe may have a positive impact on the Slovak business environment. Under the new system, there is a more detailed list of those delicts which are to be subject to penalization.

The Amendment also introduces limits for maximum penalties in the amount of 2% of the entity's assets and will range from EUR 1,000 up to EUR 1,000,000 depending on the nature of the delict and the size of the entity to be penalized.

The new penalty system will apply to tax proceedings initiated after 31 December 2011.

b) Change in filing financial statements and annual reports

The Amendment sets up a register to be used for filing financial statements as well as other selected accounting documents. The register should archive documents from 2013. The Ministry of Finance will administer the register.

Annual reports will continue to be stored in the Collection of Documents.

c) Other

The Amendment changes the accounting period for entities under liquidation or bankruptcy proceedings. The accounting period is to equal the period of the respective proceedings, i.e. it may be longer than one year.

The Amendment also includes changes relating to valuation of the purchase/sale of foreign currency and derivatives in foreign currency.

There are also new criteria for the preparation of consolidated financial statements.

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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Transfer pricing audits - recent experience

Over recent years the Slovak tax authorities have shown increased interest in the area of transfer pricing. Recent experience shows an increase in the number and intensity of tax audits in this area. Here we summarize the areas the tax inspectors investigate and the information usually required in the course of transfer pricing audits.

It is our experience that, within corporate income tax audits, the tax authorities routinely require the transfer pricing documentation as per the 2009 legislation. It is worth noting that transfer pricing documentation is also often requested for the years prior to 2009.

As for the scope of information requested by tax authorities within transfer pricing audits, the areas of focus are mainly the following:

- ▶ ownership structure of the Group to which the taxpayer belongs
 - ▶ scope of business of the foreign related parties performing transactions with the taxpayer
 - ▶ annual report of the taxpayer and of the Group
 - ▶ primary documents regarding the related party transactions (invoices, contracts etc.)
 - ▶ budgeting process and related calculations (if prices are set on the basis of budgets)
 - ▶ calculation of costs incurred in respect of related party transactions
 - ▶ overview of the product categories (types of products) and services within transactions between foreign related parties
 - ▶ in the case of goods transactions, the subsequent processes in the value chain (beyond the activities performed by the taxpayer)
 - ▶ Group transfer pricing guidelines and accounting guidelines
 - ▶ one-off transactions with related parties
 - ▶ detailed calculation of year-end transfer pricing adjustments
 - ▶ potential comparable transactions with unrelated parties
 - ▶ selection of comparable companies within benchmarking studies.
- To summarize, it is apparent from recent transfer pricing audits that the Slovak tax authorities extend their attention beyond fulfilment of the mandatory documentation obligation and review related party transactions in detail.
- 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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Tax and social security reform - legislative development update

In its September session, the Slovak Parliament discussed the proposal for tax and social security reform. The reform proposal passed its first reading - the first stage of the legislative process in the Parliament.

The Parliament should discuss and vote on the proposal in its further legislative stages (second and third, final reading) in its October session. We will continue to monitor the legislative development closely and inform you accordingly.

We wish to draw to your attention that the effective date planned for the reform is 1 January 2012 and it is expected to impose significant changes and one-off implementation obligations for each Slovak employer.

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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The Social Security Agency expands its electronic/online services

The Social Security Agency is expanding its electronic/online services and gradually reducing the threshold (number of employees) determining with employers are obliged to send the relevant documents (such as registration forms and monthly reports on social security contributions) to the Social Security Agency electronically.

The changes will apply as follows:

- ▶ Employer who employs 3 and more employees - from 1 October 2011
- ▶ Employer who employs 2 employees - from 1 November 2011
- ▶ Employer who employs 1 employee - from 1 December 2011.

Employers need to set up access to the electronic services of the Social Security Agency in order to be able to send the documents electronically.

This change provides advantages to the employers, in particular an overview and check of the forms transmitted; it also reduces time and the costs associated with the submission of paper forms.

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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Employee benefits following Labour Code amendment

The Slovak Labour Code has been amended with effect from 1 September 2011 (by amending Act No. 257/2011 Coll.).

We noted the changes introduced by this amendment in our May edition of Tax News, when the amendment was at the stage of a government proposal under discussion in the Slovak Parliament. Now, we would like to draw your attention to changes to the salary definition and pay slip contents.

In accordance with the amendment, the salary should not (in addition to other items) include travel allowances in excess of the limits, contributions to the employee's supplementary pension insurance and life insurance, supplementary compensation to social security sickness payments, compensation for the employee's non-competition obligation after

termination of employment or any other benefit/entitlement without the characteristic features of the salary provided to an employee in connection with employment in accordance with the Labour Code, special legal provisions, collective agreement or employment agreement.

As the above implies, compensation without the characteristics of a salary may not, by definition, be considered as salary or a salary component, even if the said compensation is agreed in the employment provisions or collective agreements covering salary arrangements.

In the recent past, the corporate income tax deductibility of employees' benefits costs was the subject of a number of disputes with the Slovak Tax Directorate at the Slovak Supreme Court and County Courts, where their decisions in principle supported the corporate income tax deductibility of benefits costs (under the required conditions) and resulted in a shift of practice in favour of taxpayers.

However, taking into consideration the close link between the tax law and labour law in the area of employee remuneration, it will be necessary to analyze the impact of the above change on the corporate income tax deductibility of benefits costs in the light of precedents from former court cases.

In connection with this, we also wish to note that, in accordance with the amended Labour Code effective from 1 September 2011, the employer is obliged to state on the employee's pay slip, in addition to salary and salary components, other benefits/entitlements provided to the employee in connection with the employment. With agreement from the employee in writing, the pay slip may also be provided electronically.

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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Transaction with zero effect on final VAT liability - right for deduction of VAT/ obligation to file supplementary VAT return - judgment of the Slovak Supreme Court

We would like to inform you of the recent judgment of the Slovak Supreme Court (“the Court”) dealing with the right for deduction of VAT in transactions with zero effect on the final VAT liability.

Background

Upon delivery of a machine, the VAT payer issued the respective invoice. The output VAT resulting from this transaction was not declared by the VAT payer in the VAT return (transaction not included in VAT records, VAT not paid). At the same time, the VAT payer received an invoice for purchase of the machine from its supplier (the same supplier to which the machine was subsequently sold) in the same amount. The VAT payer neither deducted the input VAT, nor was the invoice included in the VAT records.

Following a tax audit, output VAT relating to sale of the machine was additionally assessed to the VAT payer, while the VAT deduction in respect of the purchase was not taken into consideration.

In appealing this decision, the taxpayer argued that the exclusion of certain invoices issued and received from the VAT records was solely an administrative fault and that, by netting the input and output VAT, the final VAT would have resulted in zero. For this reason, the taxpayer elected not to file a supplementary VAT return.

Decision

The Court’s decision rejected the approach of the tax administrator (confirmed by a Regional Court), largely on the basis that the conditions for claiming the right to the deduction of VAT were not duly investigated since the tax administrator focused wholly on assessing the additional VAT liability.

In the Court’s reasoning, the issue of whether the statutory conditions for the deduction of input VAT (existence of an invoice, VAT being assessed by the supplier) are met is crucial in determining whether the right to the deduction of VAT exists; it should further be demonstrated that the transaction was actually performed. The sole fact that the VAT payer has not claimed the right for VAT deduction in a VAT return may not lead to the conclusion that the right is not to be conferred.

However, as the Court stated, it was not clear from the opinion of the tax administrator whether the deduction of the input VAT was rejected because it was not claimed or because it was not proved that the delivery of the machine was actually performed as declared in the invoice.

Moreover, in its ruling, the Court stated that the tax administrator did not adequately address the VAT payer’s other argument; mainly that the right for VAT deduction could not be eliminated to its application only through a single process - submission of a VAT return, while the statutory conditions for VAT deduction were met.

In view of the above, the Court concluded that the tax administrator did not act in compliance with the relevant legislative provisions and had decided in this case prematurely, without acquiring additional evidence on the right for deduction of VAT. Accordingly, the Court cancelled the decision of the tax administrator and returned the case for further proceedings.

Practical implications

Although this case does not directly address the question of whether a supplementary VAT return is to be filed in order to claim VAT deduction in a situation where there is zero effect on the final VAT liability, the Court’s reasoning requiring that all the conditions to confer a right for deduction of VAT should be duly investigated in a VAT audit, even if the right has not been claimed by a VAT payer in a VAT return, is in favour of VAT payers.

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Amendment to Act No. 582/2004 Coll. on Local taxes and Local Charges for Municipal and Minor Construction Waste

On 19 August 2011, the Slovak Government approved the amendment to Act No. 582/2004 Coll. on Local taxes and Local Charges for Municipal and Minor Construction Waste.

If approved by the Parliament, the amendment will introduce the following changes:

- ▶ simplified classification of estates for the purposes of the real estate tax on land
- ▶ decrease in the highest applicable rates of real estate taxes on land, constructions, flats and non-residential premises

- ▶ taxation of motor vehicles in the country of their registration
- ▶ possibility for municipalities to introduce electronic communication with taxpayers.

The proposal is currently under discussion in the Parliament. If approved by the Parliament and signed by the President, the amendment will come into effect on 1 December 2011 and will be effective for tax liabilities arising after 31 December 2011.

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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