Tax and Legal News

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Content

Editorial

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The series "Taxing the Rich"

Exactly a year ago, I tried to outline the pilot of a groundbreaking tax on the rich in this space. A certain Professor Zucman spoke at the G20 meeting at the time and said, in simple terms, that the rich could pay a tax of 2% of their wealth (including that in various corporate structures) every year.

The idea didn't seem to catch on. But now, a year later, the second part of the series, Resources for a Secure and Resilient Europe, is coming from the same professor and his colleagues. This episode is based on the assumption that Europe will need €250 billion each year for its security, in addition to a number of other necessary expenditures and investments.

The authors look to the war years for inspiration. During the Second World War, Britain and France financed war expenditures through extraordinary taxation of wealthy individuals, simply put by progressive taxation of the wealthiest.

The authors argue that the idea of taxing the rich is a popular one in Europe. According to surveys, 67% of Europeans support it. This is perhaps not surprising. A slightly more compelling argument would be the real data presented on effective taxation as a function of wealth. 99% of the population in the major European economies pay taxes at a broadly stable average rate of somewhere above 40% (let's be happy with our tax rates, by the way). The wealthiest 99%-99.999% of the population, according to the presented data, steadily drop to 20% with their tax rate. And the lowest rate supposedly goes to the richest thousandth of a percent of the population, who are already starting to fall into the billionaire dollar club.

The data indicate that billionaires are effectively taxed much less than the rest of the population, and the authors believe this needs to be straightened out, to achieve greater fairness. The general public supports this. The authors propose a 2% or 3% annual tax on wealth. Liquidity will not be a problem for those affected, even though their wealth is invested in some way. Statistically, their wealth is said to generate an annual return of over 7% (after inflation), i.e. paying 2%-3% in taxes will be easy according to the authors (the authors probably arrive at these figures by applying approx. 25% tax rate to the 7%-10% assumed return). Taxes paid on income are supposed to be creditable against this wealth tax, meaning no double taxation.

The authors have already identified the billionaires concerned on a country-by-country basis. They are serious. In the Czech Republic there are reportedly 11. France tops the list with 147, but we are still about eighth in Europe.

But the authors go even further and propose to tax euro centi-millionaires, i.e. people with assets over 100 million euros. In this case, a 3% tax would raise €121 billion in the EU.

In the Czech Republic alone, according to the authors, the additional tax collection from 11 billionaires (at a 3% rate) would be €1.7 billion (40 billion crowns), or €3.1 billion (72 billion crowns) after including the centi-millionaires. For comparison, the total personal income tax for the whole country is about 150 to 200 billion crowns annually.

We'll see if there's another episode of the series and how quickly it comes out. Defense spending is sure to be a big topic, and it will be tempting to collect roughly half of what we collect from the rest of the population.

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Pillar 2 and transfer pricing

Do the Pillar 2 rules consider transfer pricing? Yes, they do. A special treatment applies to application of the full rules, and it's not exactly straightforward reading.

What the Model Rules and Czech law tell us

In the context of applying the full rules, Article 3.2.3 of the Model Rules (§ 44 of the Czech Act on Top-Up Taxes) specifically refers to this area. Simply put, the article states:

- *For cross-border group transactions* – a transaction that is not recorded at the same amount in the financial statements of the entities or is not recorded in accordance with the arm's length principle shall be adjusted to be recorded at the same amount for those entities and in accordance with that principle;
- *For domestic group transactions* – if the loss on the transfer of an asset is included in the calculation of the qualifying income and is not recorded in accordance with the arm's length principle, it shall be adjusted in accordance with that principle.

The Commentary

At first glance, the rules sound relatively clear. But as is the case with Pillar 2, one must look at the Commentary before forming an opinion.

Upon inspection, we find that the Commentary pushes the above rules quite a bit and, among other things, comes up with the following principle with respect to cross-border transactions: a unilateral transfer pricing adjustment will result in a corresponding adjustment to the counterparty's qualifying income under Article 3.2.3, unless the transfer pricing adjustment increases or decreases taxable income in a jurisdiction that has a nominal tax rate below the minimum tax rate or that was a low-tax jurisdiction in the two years preceding the adjustment.

This "clarification" is intended to ensure that no adjustment leads to double taxation or non-taxation in the context of Pillar 2.

Examples of cross-border transactions where the adjustment is not made

Examples of situations where a qualifying income adjustment will not be made include the following:

- A unilateral transfer pricing adjustment that reduces taxable income in a low-tax jurisdiction should not be taken into account in a qualifying income because if the counterparty is located in a high-tax jurisdiction, such an adjustment would result in double non-taxation in the context of Pillar 2 (i.e. the adjusted income would not be taxed in any jurisdiction and would not be subject to a top-up tax).

- A unilateral transfer pricing adjustment that increases taxable income in a low-tax jurisdiction should not be taken into account in a qualifying income because such an adjustment would result in double taxation in the context of the Pillar 2 rules (i.e. the adjustment would subject the income to additional tax in the jurisdiction in which the unilateral adjustment was made and the income is already subject to local tax in another jurisdiction).

The Commentary significantly shifts the dimension of the Pillar 2 special rules for transfer pricing adjustments.

Complicated

According to the author, the above is not at all easy to absorb and certainly not to apply in practice, which yields a variety of possibilities.

Among other reasons, the adjustment appears to us to be problematic because in our view it does not provide clear guidance for dealing with the related tax adjustments or the impact of any associated additional settlements.

Therefore, where possible, it is always better to account for the effects of a transfer pricing adjustment in the period to which it relates.

Thus, if you have a transfer pricing adjustment situation, you need to assess the situation carefully and choose a reasonable solution in the context of the Pillar 2 rules outlined above.

If you are interested in this area, please contact the author of the article or your usual EY team.

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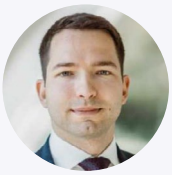

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News on competition law and FDI

The month of March brought several interesting changes in the area of competition law and foreign investment screening.

1. First ever ban on investment in the CR

For the first time in the period of effectiveness of the Foreign Investment Screening Act[1] ("the Act"), the Czech Government applied the possibility to prohibit a foreign investment due to a threat to the security of the Czech Republic or domestic or public order.

According to publicly available information, the Government issued a resolution that the investment of a Chinese company in the form of the placement of satellite service equipment on the territory of the Czech Republic may pose a threat to the security of the Czech Republic or to domestic or public order, and ordered the Ministry of Industry and Trade ("MIT"), as the competent authority, to issue a decision on prohibiting the continuation of this foreign investment.

The MIT has not published any information on this matter, but several interesting partial conclusions can be drawn from the publicly available information regarding this case and the application of the Act in general:

- State authorities monitor the market situation – Most likely, in this particular case, the investment did not meet the criteria for mandatory notification prior to the investment. Therefore, the MIT apparently used the possibility to review the foreign investment within 5 years of its implementation, based on the initiative of the Security Information Service. In this context, the Act allows foreign investors to initiate a voluntary consultation with the MIT. If the MIT does not initiate a foreign investment review procedure following the consultation, the MIT cannot review the foreign investment retroactively after its implementation (except if false information is provided in the request to initiate the consultation).
- The Act applies to various forms of investment – In this case, the investment took the form of the construction and operation of a satellite service facility on land leased from a third party. The Chinese company neither set up a local legal entity to manage the investment for these purposes nor acquired a stake in the Czech company from a third party in order to realise the investment. The law therefore applies not only to capital investments in the form of disposals of shares in Czech companies

1 Also abbreviated as the FDI Act

(share deal), but also to other types of asset disposals (asset deal), or even to purely contractual relationships in the form of a lease without acquisition of title.

The Act allows the MIT to impose a ban on the exercise of property rights and order the sale of the target item (i.e. in this case, the satellite service equipment) if it is necessary to ensure the security of the Czech Republic or domestic or public order. It can be assumed that the MIT will do so in this case.

The Act has been effective since 2021 and applies only in relation to foreign investments made in the Czech Republic by investors from a non-EU Member State.

Therefore, prior to any transaction that meets the above criteria, we recommend you consider conducting a consultation under the Act on a voluntary basis to eliminate the risk of the transaction being reviewed retrospectively by the MIT and thus avoid unpleasant post-transaction surprises.

2. Office for the Protection of Competition has taken the exceptional step of allowing mergers

It has recently been reported in the Czech media that the Czech Office for the Protection of Competition ("OPC") has initiated proceedings to annul the decision allowing BB Global to acquire exclusive control over BigBoard Praha, and has also issued an interim measure prohibiting BB Global from exercising shareholder rights in BigBoard Praha.

The OPC's decision is not publicly available, however, according to publicly available information, the grounds for initiating proceedings for annulment of the decision and interim relief are the OPC's suspicion that it authorised the merger on the basis of documents, data and information that may have been wholly or partially false or incomplete, or on the basis of BB Global's failure to disclose to the OPC that it operates in the same relevant markets as BigBoard Praha. The misrepresentations should have related to who exercises control over BB Global, which may have a material impact on the determination of the relevant markets concerned.

The OPC issued its decision to clear the merger in November 2024.

Why are we drawing attention to this decision of the OPC? Because this is a very unusual step in the decision-making practice of the OPC in the area of merger clearance. The issuance of a preliminary injunction prohibiting the exercise of shareholder rights and the potential threat of reversal of the merger clearance decision represents a significant interference in the corporate life of the company. As a last resort, the OPC may, as part of its final decision, order the sale of the company.

This move generally demonstrates the increasing activity of the OPC in this area, and this trend can be expected to continue in the future. As can be seen from this case, the OPC monitors the market situation quite closely and has good information about the business environment in the Czech Republic.

We therefore recommend that due attention be paid to the preparation of the documentation for the merger authorisation procedure.

3. New OPC information sheet on vertical agreements

In March, the OPC issued a new information sheet dealing with vertical agreements.

Vertical agreements are a type of "cartel" agreement alongside horizontal agreements. Vertical agreements are agreements between competitors operating at different levels of the goods market. A typical example is an agreement between a producer of a good and its seller or distributor.

It is clear from the Information Sheet that one of the main areas on which the OPC intends to focus its activities is, in line with previous practice, the area of vertical resale price maintenance (RPM) agreements. These are agreements to fix prices for the resale of certain goods at retail, which are generally considered to be "target"[2] prohibited agreements. Their basic essence is to prevent customers from being able to compete on price below a certain level. Loosely translated, this means that a buyer may not, under an RPM agreement,

2 They are considered to be anticompetitive and therefore automatically prohibited; the OPC does not have to prove their actual negative effect on competition when imposing a fine.

discount goods for its customer more than it has agreed with its supplier, while it is clear that the price of goods is and always will be one of the key parameters by which it fights for customers by default. Such agreements are almost always found by the OPC to be anti-competitive. OPC intends to continue the trend set in this area and to conduct a high number of local investigations. The OPC has also recently imposed record fines in this area in the tens to hundreds of millions of CZK.

If you have any questions regarding competition law, please contact the authors of this article or other members of EY Law or your usual EY team.

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Is there a shift in VAT deductions for holding companies?

In her opinion in Case C-808/23 Högkullen, the Advocate General of the CJEU came up with some novel ideas. Some of them may be quite dangerous, while others present an interesting opportunity.

What are the details?

A Swedish holding company provided its subsidiaries with support services (e.g. management, financing, property management, IT and HR); its remuneration amounted to approximately SEK 2.3 million.

The tax administrator didn't like the fact that the holding company only paid VAT on SEK 2.3 million, while its total costs amounted to SEK 28 million (about half of which was purchased services for which the full deduction was claimed; the rest was for wages, for example).

He therefore argued that the services provided by the holding company should have been valued for VAT purposes at the amount of all costs incurred and assessed tax on the amount of SEK 28 million.

An important motivation was that the subsidiaries provided exempt supplies and had a limited right to deduct input VAT.

Arguments of the holding company

The company defended itself, in particular by referring to the fact that it followed the standard OECD rules for transfer pricing. The remuneration of SEK 2.3 million was determined on the basis of the related costs and a mark-up (cost-plus method).

It also argued that other costs of the holding company cannot be transferred to the subsidiaries as they are not related to them – these are so-called shareholder costs, e.g. costs of accounting, audit, the general meeting, raising capital of the parent company, etc.

Suggestions for a change in interpretation

Advocate General Kokott makes it quite clear in her introduction that she does not agree with the current case law of the CJEU, even though it is already quite long-standing and settled case law.

She accuses the SDEU, among other things, of encouraging holding companies to create artificial constructs, in particular to provide services to subsidiaries.

Rather surprisingly, the Advocate General suggests that a holding company's right to deduct could be inferred from the fact that it "carries on an indirect economic activity" through its subsidiaries.

This could have a positive impact on current "passive" holdings. However, there could be negative consequences for "active" parent companies whose subsidiaries are not fully entitled to the tax deduction. Therefore, it also suggests that the tax administrator should have rather tried to question the entitlement to an input deduction.

VAT on services to subsidiaries

The Advocate General disagrees with the assessment of output VAT in this case.

First, she notes that the services provided by the holding company do not constitute a specific indivisible "package" (as argued by the tax administrator). On the contrary, they are ordinary support services which must be considered separately (e.g. accounting, IT support, financing, etc.). As these services are separately measurable, the entire cost of the holding company cannot be used as the tax base.

Usual price in VAT

The reasoning of the Advocate General regarding the application of arm's length pricing between related parties is also very interesting.

This is a specific rule to prevent tax evasion. However, according to the lawyer, the risk of losing tax revenue is only for those expenses for which a tax deduction has been claimed. As the holding company has only claimed tax deductions on half of its costs (approximately SEK 14 million), the tax authority can only claim output VAT on this amount (not on the full SEK 28 million). In addition, some of the capital expenditure should have been included over several years.

This could have a significant impact on the application of § 36a of the ITA, which implements this rule.

Practical impacts

Some of the Advocate General's thoughts are quite surprising. It will therefore be interesting to see how the Court of Justice of the EU will deal with them in its final decision, or whether it will avoid unravelling them. However, even if in this case, they may still provide inspiration.

In the meantime, we recommend increased caution in similar situations, or consideration of all possible procedural steps when exercising the above-mentioned opportunities.

If you have any questions about the above topic, please contact the author of the article or your usual EY team.

The Advocate General's opinion introduces some uncertainty into the application of VAT to holding structures and it will be interesting to see how the CJEU responds to her arguments. However, it also contains some interesting ideas and opportunities that we recommend considering now.

Judicial window

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Deductibility of interest on refinancing and for early invoice payment incentives

In this issue, we bring you a Supreme Administrative Court (SAC) ruling on the tax deductibility of interest – in two forms (6 Afs 294/2023 – 78).

First form – deductibility of interest on refinancing

- In the past, the company received an interest-bearing loan from its shareholders.
- After some time, the company effectively replaced these loans by issuing (longer-term and higher interest-bearing) crown bonds, which were again subscribed by shareholders.
- In this regard, the company stated, inter alia, that in the context of the change in its business profile, it needed to secure long-term financing.
- The tax administrator comes in and challenges the deductibility of the interest on the bonds in question, arguing that the company failed to prove the title of the obligation that was refinanced by the bonds, and also failed to prove a direct and immediate relationship between those expenses and the expected income. The tax administrator did not accept the argument about the need to secure long-term financing on the grounds that the company had nothing to worry about given its loans from shareholders.
- The courts sided with the company.
- The SAC stated, inter alia, that if interest on a loan financing the payment of dividends to shareholders is a deductible expense, then interest on new loan financing (here, the issuance of bonds) to replace earlier debt financing (including from persons related to shareholders) with a shorter, or approaching, maturity must be a deductible expense.
- According to the SAC, the higher interest rate itself is not surprising if the previous loans were granted with shorter maturities.
- Thus, according to the SAC, the cost of obtaining the funds from the bond issue used to pay existing liabilities constitutes an expense incurred for the purpose of maintaining taxable income, since without obtaining this (or other) long-term debt financing, the company would have been forced to sell off its assets or reduce its spending on them in advance in order to pay its existing liabilities as they matured, which could have reduced the scope of its taxable income.

Second form – interest for early invoice payment

- A company paid interest to its customer, a subsidiary, for payment of invoices before their due date and claimed the interest as tax deductible.
- The tax administrator did not like this – arguing, inter alia, that the interest implies the provision of debt financing, which did not happen in this case.
- The courts again sided with the company.
- According to the SAC, the costs incurred to motivate the debtor to pay earlier (which reduce the margin achieved on the sale) are without reasonable doubt incurred to achieve taxable income. Such 'income', according to the SAC, is to be understood as the revenue from the additional goods produced as a result of the intensification of production.
- From the point of view of calculation, according to the SAC, the agreed scheme does indeed act as interest, but its economic and legal nature is nothing more than a discount on the price for early payment of the invoice.
- The SAC therefore concluded that the cost associated with the discount thus provided was an expense for the purpose of obtaining taxable income. If the company had not achieved the earlier payment of the invoices by means of an 'interest' incentive, it would have had to either borrow the funds needed for intensified production (at a tax-deductible interest cost), or obtain it by selling (assigning) the invoice receivables through forfaiting (with a tax deductible cost arising from the difference between the redemption price and the nominal price of the assigned receivables), or it would have to reduce the scale of production to a level commensurate with the currently available funds, and thus resign itself to higher taxable income.

In this decision, the courts clearly went to the economic substance of the arrangements/ transactions at issue and found in favor of the taxpayer on both elements.

If you are interested in this area, please contact the author of the article or your usual EY team.

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Did you know:

- The GFD launched a web form to ask professional tax questions?
- A new legislative amendment of the Top-Up Tax Act amendment has been introduced?
- An amendment concerning ESOPs has been published in the Collection of Laws?
- The Government has approved a draft regulation setting out the conditions for obtaining special long-term residence?
- The Constitutional Court has commented on the case of a rejected claim for interest on incorrectly assessed and subsequently refunded customs duty?
- The tax administration has an interesting interpretation of the extension of the tax assessment deadline for the specific timing of filing a supplementary tax return?
- The SAC issued a decision dealing with the legitimacy of the creation of accrual for damages?