Tax and Legal News

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Contents

Editorial

Karel Hronek
karel.hronek@cz.ey.com
+420 731 627 065

The Pillar pathologies of incentives

We can argue about it, we can disagree, but the reality seems to be that without various forms of tax incentives and credits, the medium-sized Czech economy would not be competitive. In the Czech Republic, there is an ongoing professional and political debate about the form, scope and objectives of incentives and the extent to which externalities prevail. All this is taking place amid relatively low unemployment and low GDP growth, while, at the same time, there is a trend of shifting low-added--value activities elsewhere and factory closures in our country.

The new OECD/EU tax legislation known as Pillar 2 BEPS 2.0, which the Czech Republic has adopted with effect from 2024, has entered the decision matrix of whether or not to have incentives, and if so, in what form. It forces large multinational groups to make complex calculations about the effective taxation of their companies' profits on a jurisdictional basis. If the effective taxation is low, a top-up tax is applied, bringing taxation of the so-called excess profits (profits after taking into account substantive parameters - employees and tangible assets) to 15%. Complex rules, lots of exceptions, a gradual ramp-up, transitional provisions, safe harbours and dangerous waters full of complexities - all in one law.

One of the more complicated issues is tax credits, or if you prefer in the Czech Republic, investment incentives, subsidies and various tax deductions. Although one would expect that if a company receives an incentive, uses it and complies with its rules, no one can take it away. Wrong, they can. Pillar 2 divides the credits into 2 groups. The correct ones are called qualified refundable tax credits, which are paid to businesses within 4 years. These are then treated as income in the effective tax calculation and do not have as much impact on the effective tax.

Czech investment incentives and R&D deductions do not belong to this group. This means that even if the investment incentives reduce the corporate tax to zero, any excess profits are subject to 15% and the amount is paid to the state. And the incentive is over, at least in part. It may not even help anymore if the investment incentive was granted in the past and the company booked a deferred tax asset (which increases the effective tax rate when "used").

Last month, the OECD issued new administrative guidance on Pillar 2. One guidance focuses specifically on the treatment of deferred tax assets arising after 30 November 2021 from government agreements or elections relating to tax treatment with retroactive effects. The guidance says that the tax expense resulting from the "use" of such deferred tax assets should generally be excluded from the covered taxes for purposes of applying the Pillar 2 rules and from the simplified covered taxes for purposes of applying the CbCR safe harbour transition rules. The guidance at least introduces an exception to this general rule in the form of a two-year grace period during which a limited amount of this tax expense may be included for both purposes in certain circumstances. The question is whether this administrative guidance will also apply to Czech investment incentives.

However, neighbouring countries are already seizing the opportunity and adjusting the rules to get the Pillar 2 tax credits right. Hungary and Austria already have them, Poland is working on it. In our country, there seems to be silence. This will give these neighbouring countries a comparative advantage over us.

Isn't now a good time to look at the whole package of incentives and subsidies and consider its strategic, long-term set-up? A simple comparison with neighbouring countries shows our current range of investment incentives and subsidies to be unattractive and inadequate.

Isn't now a good time to look at the whole package of incentives and subsidies and consider its strategic, long-term set-up? A simple comparison with neighbouring countries shows our current range of investment incentives and subsidies to be unattractive and inadequate.

Financing

Radek Matuštík
radek.matustik@cz.ey.com
+420 603 577 841

Germany issues guidance on transfer pricing / deductibility considerations for intra-group financing

German tax authorities have issued updated administrative principles on transfer pricing, including guidance on new rules addressing intra-group financing.

What caught our eye?

What caught our eye are the following requirements / tests applied when assessing deductibility of intra-group financing (our high level understanding):

- One of the requirements is that the taxpayer has to be able to demonstrate that principal and interest payments can be serviced throughout the entire term of the financing period (debt-serviceability test).
- A managing director should generally not take on external debt unless there is at least a reasonable expectation of a return that covers the financing costs, i.e. a quantitative analysis to satisfy the business-purpose test is expected.
- German tax authorities seem to require a number of additional criteria be fulfilled, such as a defined term of the loan, interest being charged based on agreed payment terms and the general ability of the borrower to borrow funds from third parties at comparable conditions.
- Financing of a dividend distribution to shareholders is a valid business purpose if it is done within the framework of the typical distribution policies. The taxpayer should consider its options realistically available which likely means that available excess cash (i.e., cash not required for the business and not generating a return higher than the financing costs) should be used before any additional funds are borrowed (this generally does not preclude the holding of arm's-length liquidity reserves or capital buffers).
- For further details please see the tax alert of our German colleagues here.

What is our takeaway?

The guidance contains many interesting considerations that may serve as an inspiration also for us in the Czech Republic – taxpayers as well as tax authorities.

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

According to the German guidelines, financing of a dividend distribution to shareholders is a valid business purpose if it is done within the framework of the typical distribution policies. The taxpayer should consider its options realistically available which likely means that available excess cash (i.e., cash not required for the business and not generating a return higher than the financing costs) should be used before any additional funds are borrowed.

Pillar 2

Karel Hronek
karel.hronek@cz.ey.com
+420 731 627 065
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OECD releases new documents on GloBE rules and on qualified jurisdiction status

OECD released technical documents on the operation of the GloBE Pillar 2 Rules.

Key documents include:

- new Administrative Guidance on the application of Article 9.1 ("9.1 AG"),
- new Administrative Guidance on a Central Record of Legislation with Transitional Qualified Status ("Central Record AG"),
- updated GloBE Information Return (GIR) document, related new Administrative Guidance on Article 8.1.4 and 8.1.5 (GIR Guidance) and new documents related to the exchange of GIR information such as Multilateral Competent Authority Agreement on the Exchange of GloBE Information (GIR MCAA).

9.1 AG

The 9.1 AG mainly focuses on DTAs arising after 30 November 2021 from governmental arrangements as well as from elections and choices regarding tax treatment that have retroactive effects. The tax expense resulting from the reversal of such DTAs should generally be excluded from Covered Taxes for purposes of the application of the GloBE Pillar 2 rules and from Simplified Covered Taxes for purposes of the application of the Transitional Country-by-Country Reporting (CbCR) Safe Harbour rules. It also introduces a two-year Grace Period during which a capped amount of that tax expense can be included for both such purposes.

A DMT in a jurisdiction that provides such benefits and do not apply the above guidance may not have qualified status as a Qualified Domestic Minimum Top-up Tax (QDMTT) or for purposes of the QDMTT Safe Harbour.

Central Record of Legislation

The Central Record AG includes the Central Record of Legislation with Transitional Qualified Status listing the jurisdictions with legislation that has completed the transitional qualification mechanism process for the Income Inclusion Rule (IIR), the DMT or the QDMTT Safe Harbour, together with explanatory information.

The Central Record AG provides that this process is a simplified procedure that allows swift recognition of the qualified status of implementing jurisdictions' legislation on a temporary basis, pending the development of a full legislative review and ongoing monitoring process.

Updated GIR document and GIR Guidance

The updated GIR document contains a revised standardized template for the GIR.

Like the original document, the updated GIR document states that the obligation to prepare a GIR is separate from the requirement to declare and pay taxes under a tax return. Each implementing jurisdiction will determine its tax return filing and payment procedures for the global minimum tax. While some jurisdictions may need additional data points beyond the data in the GIR for tax return preparation (e.g., converting Top-up Tax liability into domestic currency), the document indicates that jurisdictions should generally avoid requesting additional data related to the calculation of a Constituent Entity's Top-up Tax liability. The document also indicates that the standardized GIR template does not preclude a tax administration from requesting necessary supporting documentation.

The GIR should generally be completed based on the GloBE Model Rules and Commentary with some exceptions. In some situations, the MNE Group will have to include some information in the GIR on the differences between applicable domestic legislation and the Model Rules.

GIR MCAA

The GIR MCAA is a multilateral agreement that provides for information exchanges on an automatic basis.

The GIR MCAA provides for maintenance and publication on the OECD website of a list showing the jurisdictions that have signed the agreement and the jurisdictions between which there is an active exchange relationship for GIR information.

What's the takeaway?

A quick glance at the model information return shows that an enormous volume of data is required. Companies will also have no choice but to continuously monitor local specifics. We will be happy to help you with all this.

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

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Dušan Kmoch
dusan.kmoch@cz.eylaw.com
+420 704 865 114

Klára Hurychová
klara.hurychova@cz.eylaw.com
+420 603 577 826

Constitutional Court grants legal persons the possibility to claim compensation for non-pecuniary damage

In its ruling, the Constitutional Court dealt with a constitutional complaint in which the complainant, the registered association Milion Chvilek z.s., sought to annul the decisions of the general courts, which rejected the complainant's claim for compensation for non-pecuniary damage allegedly caused by unjustified interference with its reputation. In the specific case, Milion chvilek, z. s. sought an apology for statements made by the former chairman of the Czech Communist Party, who indirectly linked the complainant to the cyberattack on the Benešov hospital.

The complainant considered the decisions of the general courts denying it compensation for non-pecuniary damage to be unconstitutional. It sought the annulment of the provisions of § 135 and § 2894(2) of Act No 89/2012 Coll., the Civil Code ("the Civil Code"), on the grounds that they were contrary to the constitutional order.

In assessing the complainant's claim for damages, the general courts assumed that the obligation to compensate for non-pecuniary damage can only be awarded if it is agreed between the parties or if the law expressly provides for compensation (pursuant to § 2894[2] of the Civil Code). Thus, in view of the wording of § 135(2) of the Civil Code, which grants a legal person protection of its reputation and privacy, but does not allow it to claim compensation for non-pecuniary damage, the Court did not award the complainant such compensation. The general courts also supported their conclusions by the decision of the Supreme Court of 30 November 2021, Case No. 23 Cdo 327/2021. In this decision, the Supreme Court explicitly concluded in a similar case that *"given that the legislator did not include unjustified interference with the reputation of a legal entity in the range of specially defined cases that are associated with the right to compensation for non-pecuniary damage within the meaning of § 2894(2) of the Civil Code, the Supreme Court concluded that after the "new" Civil Code came into force, a legal entity does not have this right."*

The First Chamber of the Constitutional Court referred the decision to the full court. Although the Constitutional Court, headed by Judge Rapporteur Jaromír Jirsa, rejected the complainant's motion to annul the provisions of the Civil Code in question, it also opposed the conclusions of the general courts. It stated that *"the effective protection of the reputation of legal persons, constitutionally guaranteed by Article 10(1) of the Charter of Fundamental Rights and Freedoms, requires the analogous application of the same remedies as for protection against unfair competition under § 2988 of the Civil Code, including the possibility for the legal person to claim adequate compensation"* for the non-pecuniary damage caused.

The provision of § 135(2) in conjunction with § 135(1) of the Civil Code allows a legal person in case of unjustified interference with its reputation to claim 1) abstention from it (abstention claim) or 2) removal of its consequences (removal claim). In addition, a legal entity may claim 3) compensation for property damage and 4) the release of unjust enrichment, if the statutory prerequisites are met. The Constitutional Court found this list to be insufficient and failing to allow legal persons to claim effective protection. It summarised that *"the right to adequate compensation provides the injured party with the possibility to at least partially compensate for the non-pecuniary damage caused by the damage to its reputation in a situation where abstention and removal claims fail to respond to the uncontrolled dissemination of defamatory information in the public domain. At the same time, it allows compensation without the need to prove the amount of the damage and its direct link to the harmful conduct, which is often practically impossible."*

The Constitutional Court proceeded from the interpretation of Article 10 of the Charter, according to which everyone has the right to have his or her human dignity, personal honour, reputation and name protected. Although it is clear that some of these rights by their nature belong only to natural persons, in the case of the protection of reputation, such protection may also be granted to legal persons. According to the court, legal persons are not merely an arbitrary legal fiction, but are primarily a tool by which people pursue their goals or interests. Reputation thus plays a key role in the performance of legal persons in legal relations and in the fulfilment of the rights of the individuals associated with them, and they may suffer material and non-material damage if it is unlawfully interfered with.

However, the Court did not find that the most appropriate means of protection for legal entities was not to repeal the contested provisions of the Civil Code, but to apply the catalogue of remedies provided for protection against unfair competition in § 2988 of the Civil Code by analogy, including the possibility to claim adequate compensation.

What's the takeaway?

From the point of view of the business environment, i.e. in particular companies, but also other legal entities such as associations and special interest groups, the decision is certainly welcome, as it paves the way for them, in addition to existing claims, to obtain possible compensation (either in the form of an apology or in the form of financial compensation for the damage suffered) for interference with their reputation.

However, with this decision, the Constitutional Court opens an imaginary Pandora's box for assessing which constitutionally guaranteed rights may belong to legal persons and which private (tort) rights are bound to them. Traditionally, domestic law has been based on the so-called anthropocentric concept, i.e. it binds natural rights, or legal personality, to human beings, whereas it considers a legal person to be an organized entity whose legal personality is "only" artificially constructed and recognized by the law, and thus only the law defines the scope of its rights and obligations. However, we are now moving in a direction which (hypothetically, for the time being) will make it possible to infer the possibility of satisfaction for, for example, interference with the right to religion of a legal person. After all, the very right to religion of private companies was upheld in 2014 by the United States Supreme Court in the Hobby Lobby case.

A dissenting opinion of a group of constitutional judges explicitly points to the risks associated with this ruling. According to the dissenting judges, legal persons (as legally created constructions) do not have rights under Article 10(1) of the Charter, nor do they have a constitutional right to compensation for non-pecuniary damage as a means of protecting their reputation. According to them, the existing interpretation of the Civil Code, as given by the Supreme Court's case law, corresponded not only to the text, system and concept of the Civil Code, but also to the existing case law of the Constitutional Court (refer to I. ÚS 3819/14 in the case of Karlovarské minerální vod, a.s.). According to a minority of judges, the finding thus introduces an undesirable and unsystematic non-property, moral dimension into the relations of legal persons, which are themselves a purely economic construct.

If you have any questions about how to protect your company's rights, or any other questions you may have while reading this, please contact the authors of this article or other members of EY Law or your usual EY team.

In its ruling of 15 January 2025, the Constitutional Court granted legal persons the right to adequate compensation for non-pecuniary damage caused.

VAT

David Kužela
david.kuzela@cz.ey.com
+420 731 627 085

Kristýna Daňková
kristyna.dankova@cz.ey.com
+420 735 729 322

Changes in VAT on real estate

The current, very comprehensive VAT Act amendment also significantly changes the rules concerning real estate. Most of these changes take effect from 1 July.

Shift in the taxation of new constructions

One of the most significant changes is the reduction of the time limit for taxation of the transfer of new buildings and real estate after significant reconstruction from the current five years to less than two years.

Delivery of the property will be exempt upon the elapse of 23 months from the month of completion of the construction (or substantial change, see below).

Only the first transfer of the property within the time limit will now be taxed; the second and any subsequent sales will be exempt.

The legislator admits that the aim of these amendments is to bring the Czech rules in line with the EU Directive. It may therefore be interesting to consider whether it would not have been possible to use them even before the amendment came into force on the basis of the so-called direct effect of EU law.

A fundamental change to a substantial change

The VAT Act will now contain a clear definition of a "substantial change" to real estate, which is important for (non-)application of VAT in the case of its reconstruction. Until now, this has only been regulated by the General Financial Directorate (GFD) methodology. The new rule differs significantly from the current one.

A substantial change will occur if (i) the cost of the change exceeds 30% of the tax base on a subsequent sale of the property (currently 50%, but on a different basis) and (ii) it is intended to change the use or conditions of occupation of the property.

The fact that it is necessary to know the final price in order to (not) apply VAT on the transfer may be a complication in borderline cases. Nor do the rules explicitly provide for the possibility of an additional change in the sale price. On the other hand, this is a practical simplification compared to the initial draft of the amendment.

The law also assumes that the related costs will be incurred by the seller (or transferor). It omits, for example, costs incurred with their consent by the tenant.

It will be interesting to see whether and how the forthcoming GFD methodology will deal with these uncertainties.

Clarification of the definition of building land

The rules for the transfer of land are newly allocated to a separate section of § 55a of the ITA.

Today's problematic definition of building land includes, among other things, a wide range of "administrative actions". It will now be crucial whether the land can be developed on the basis of existing planning documentation, which should increase legal certainty for taxpayers. An exception will be made for land where the location of a building is highly unlikely.

Land on which preparatory construction work is underway remains building land.

However, contrary to recent SAC case law, the new rules do not take into account the intent of the contracting parties.

Internally-generated assets

The amendment deletes the very problematic treatment of internally-generally assets. It can lead to a substantial increase in VAT, for example in real estate projects where part of the rent is exempt from tax, which is typical for residential buildings.

Although technically this change is already effective as of January, the transitional provisions effectively extend the life of the old rules to buildings completed by the end of 2025. In these cases, we recommend careful consideration of (not) applying the older rules.

Tax rate for residential buildings

A relatively large number of changes and refinements are also being made to the rules for applying the reduced VAT rate, for example:

- The illogical definition, whereby a residential building with a single "non-social-housing" flat was subject to the standard VAT rate, is being changed. The new test will be whether social-housing flats account for more than half of the total floor area.
- The reduced rate will also apply to transfers of unfinished buildings.
- Rules for construction work on "non-residential" buildings, part of which is used for housing, are clarified.
- The link to the registration of buildings in the territorial identification register (RÚIAN) is strengthened.

Methodology under development

In January, the GFD announced that it is preparing several interpretative publications on the current amendment to the VAT Act, one of which should also address the taxation of real estate.

It should cover not only the new rules effective from 1 July 2025, but also other areas of concern, replacing the already outdated and in many ways superseded 2015 methodology. We will therefore monitor further developments closely.

Conclusion

Although the current amendment brings with it certain pitfalls, in many cases it can also lead to interesting savings and simplifications in real estate transactions.

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

The current very comprehensive amendment to the VAT Act also significantly changes the rules concerning real estate. Most of these changes take effect from 1 July.

Judicial window

Radek Matuštík
radek.matustik@cz.ey.com
+420 603 577 841

Warning on certain holding structures

In this issue, we bring you an important recent Supreme Administrative Court (SAC) judgment on the topic of abuse of law in a holding structure.

Background (simplified)

- At the start, Company A was approximately one-quarter owned by each of four individuals (the original shareholders).
- Restructuring was carried out in 2015.
- In the first step, Holding X was established, into which the individuals probably contributed their shares in Company A outside the share capital (the judgment refers to the contribution of shares by way of a premium outside the share capital [SC], or a non-cash premium outside the SC).
- In the second step, the individuals (original shareholders) contributed shares of Holding X (again, the court talks about contributing shares through a premium outside the SC) to the newly established 4 holdings (Y1, Y2, Y3, Y4), i.e. each original shareholder now holds 100% of the shares in "his" Holding Y (1 to 4), which held approximately one quarter of the shares in Holding X, while Holding X held 100% of the shares in the original Company A.
- Subsequently, the shares held by Company A were spun off into Holding X.
- In the following years, Company A paid profits exempt to Holding X - which in turn were then paid exempt as profits to Holding Y (1 to 4), with the individual - the original shareholder - accessing 'this money' tax-free through the return of the premium.
- The original shareholders argued, among other things, that the restructuring was not primarily driven by a tax motive, but to *"prepare for an intergenerational transfer of capital, eliminate business risks and set up economically efficient relationships."* In particular, there was a reasonable-sounding argument that the structure was intended to avoid the fragmentation of the shareholder structure in an intergenerational transfer.
- However, the tax administrator did not like this and assessed withholding tax on the distribution in the form of a refund of the premium (i.e. to the original shareholder from Y), citing abuse.
- The Municipal Court and the SAC sided with the tax administrator.

What's the takeaway?

- After the SAC decision in the FPPV case, there was (perhaps sometimes unrealistic) optimism. With this decision, the SAC cooled the euphoric sentiment somewhat. So the future trend, in our view, will not be at either extreme – it will not be possible to set up a holding company without a reason, nor will it be possible to prevent the setting up of holdings altogether, if there are sound economic reasons. As it happens, the viable reality will be a grey area somewhere in between, always depending on the specific parameters and context (and the luck of the presiding Chamber). We will be happy to assist you in assessing the first two factors.

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

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CONTACTS

For further information please contact either your usual partner or manager.

Corporate taxation

Lucie Říhová	+420 731 627 058
Libor Frýzek	+420 731 627 004
Ondřej Janeček	+420 731 627 019
Jana Wintrová	+420 731 627 020
Radek Matuštík	+420 603 577 841

VAT and customs

David Kužela	+420 731 627 085
Stanislav Kryl	+420 731 627 021

Personal taxation

Martina Kneiflová	+420 731 627 041
Ondřej Polívka	+420 731 627 088

Law

Ondřej Havránek	+420 703 891 387

EY

+420 225 335 111
ey@cz.ey.com
www.ey.com/cz

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Did you know:

- In 2025, there is an increase in the coverage of employees performing hazardous work in old age?
- An Anti-monopoly Office opinion explains the rules for suppliers from third countries?
- The Ministry of Industry and Trade has announced a call for applications for funding from the Strategic Investments for a Climate-Neutral Economy program?
- The GFD issued new information on VAT registration as of 1 January 2025?
- There are some important aspects to consider in relation to submission of the last VAT return for 2024?