Tax and Legal News

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Nostalgic tax memories

By the time the kind reader scrolls through these lines, the author will be nostalgically reminiscing about his first day in tax consulting just 30 years ago. Please allow me a little of that sentiment and let's reminisce together about how the world of tax has changed in that time (a generation and a half).

The laws were then fresh (1993), short and punchy. The Income Tax Act had exactly 41 sections (189 today). The accounting procedures for businesses basically had more influence on the determination of the tax base than the law itself and were often more used. The VAT Act was logically organised and fit into a thin booklet, which cannot be said of the new law, which has been in force since EU accession and is dependent on the Directive. We no longer have a customs code, which has been replaced by a pan-European code. The dreaded "Triple Tax", feared by tax consultants, has been completely dispersed. Instead, we have lots of new taxes – windfall tax, top-up tax (unfortunately, only in one direction), taxes on coal, gas and electricity, levies on cigarette filters and inflatable balloons, and so on.

The tax rates were (in the consultant's view) friendly – income tax of 42% for corporations and a progressive rate of up to 47% for individuals. Social security with no cap – no wonder the "švarcsystém" emerged then, and no wonder it was vehemently fought by the tax administration (today it has become a nice commonplace in many professions, and the tax administration may be relying on the self-cleaning effect of the impact on pension entitlements).

The penalties were not to be ignored either, 109% p.a. for VAT and a third lower for other taxes. Is today's 20% fix + 15% p.a. a major incentive?

Case law in the tax area was practically non-existent, and if it existed, it was not public. It was still almost 10 years before the creation of the SAC (Supreme Administrative Court), which is now a trendsetter. Today, we have thousands of judgments in tax cases, and artificial intelligence searches them for the most relevant rationales, reversals and principles.

The interpretations of the Ministry of Finance (there were still 10 years to go before the General Financial Directorate (GFD) was established) were non-public and inscrutable, and a well-asked and documented question led to significant tax savings in the form of a coveted non-public opinion of the tax administration on a tax issue. This is not to say that today's GFD, which issues no opinions for a change, is ideal; the idea of some transparent compromise in the form of publishing anonymized interpretations is tempting.

Abuse of law then played out on the magic rectangle 2-7-7-2: § 2(7) of the Tax Administration = real content > disguised legal relationship; § 7(2) of the Accounting Act already foreshadowed a true and fair view. The Halifax and University of Huddersfield cases, which held that the existence of a non-tax reason was still sufficient to preserve the tax benefit, were more than 10 years away. Today, despite the requirement of a prevailing non-tax reason, we have moved to within reach of the principle "consider all options and choose the least tax-advantageous one, or else it will be bad".

Tax authority checks were done on a random basis – no data analysis, red-flags, social media monitoring, cross-checking of reports or automatic international exchange of information. Checks were done on a random, hit-and-miss basis (unless there was a denunciation, which was, is and will be forever). In Prague 1, for example, once every 170 years, in Pacov every three years (not that there was more reporting there, there was just not much to check). And in a nice itemized way, travel allowances, depreciation, service costs.

Transfer pricing? § 23(7) has remained essentially unchanged since then, but the OECD (or any other) methodology has not, so this phrase has tended to be avoided by the authorities, and options have been available for experienced and creative taxpayers. Today, we have functional and risk profiles, benchmarks and binding assessments, and we can tax even the service of providing loss-making contract manufacturing to a parent company for which we don't contractually manufacture anything.

For a tax advisor, the field had not been ploughed, sometimes it was enough to find the right paragraph, sometimes there were several, often from several regulations; logic and creativity were relentlessly applied and an answer was found. And if there was no answer in the law, or rather if there were more than one, the principle of *in dubio mitius* could be relied upon, i.e. in case of doubt, favour the taxpayer. However, careful and sophisticated advisers even then applied principles common today and did well – for the tax office always has at least 5 and at most perhaps 10 years to spare – and in that time even very solid doctrines can shift.

Then it was written up in a long report (nicely detailed, because it really amused everyone – from the taxmen, to the CFO, to more than one CEO (see above for tax rates and penalties). This was then printed, faxed (usually on a Friday night, but sometimes after the whole team had spent a weekend together in the office) and then discussed in a face-to-face meeting with the client. If the fax was not ready by 11:59 pm on Sunday, a blank paper was shoved into the fax machine (the client had to get the answer by the promised "end of the week" deadline), then the whole night was spent embroidering and on Monday morning the fax mistake was resolved and the message forwarded. Today, it'll be done somewhere through Teams, the output will be uploaded to the cloud, the tracker will tick the box and a new tender will be issued to see who can do it even cheaper.

Yup, the golden nineties... .

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Pillar 2

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Pillar 2 and CbCR safe harbours – are they still safe and simple?

The full rules of Pillar 2 are extremely complicated. Our original idea of CbCR safe harbours was that their calculation and documentation should be simple. However, with each new OECD interpretation, our original idea seems somewhat naive. In particular, the Administrative Guidance from last December comes with various conditions and rules that must be followed and adhered to if companies are even going to have a chance to competently test safe harbours.

Hybrid Arbitration Arrangements

One of these new rules involves what are known as hybrid arbitration arrangements. In simple terms, we understand that these rules are aimed in particular at selected structures which, on the one hand, improve the effective tax rate and, on the other, do not cause additional tax expense (or accounting income). In such a situation, the effective tax rate should generally be "adjusted" for the positive effect of such an arrangement with a commencement/change date after 15 December 2022.

A practical example

What would a practical example be of a structure that could be affected by this limitation?

Let's say we have company A (from jurisdiction A), whose expected effective tax rate in 2024 will be below 15%.

Imagine that a related company B (from jurisdiction B) grants a loan to company A at the end of 2023.

Company B has material historical tax losses that it would not otherwise be able to utilise. It will apply those losses against taxable income arising from the loan to Company A.

On the other hand, Company A will not claim the interest on the loan for local tax purposes (i.e. its tax payable will be higher than if it had claimed the expense).

This structure therefore results in an improvement in Company A's effective tax rate with no additional tax on Company B.

It seems to us that the special limitations of hybrid arbitration arrangements might apply to this situation. To assess whether Company A's CbCR safe harbour conditions are met, the positive effect of this arrangement on its effective tax rate should be disregarded for the purposes of simplification.

What's the takeaway

Safe harbours are no longer as simple and safe as we first thought. Before they can be applied, groups have to check off various tests and rules. We'll be happy to help you with that.

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

Safe harbours are no longer as simple and safe as we first thought. Before they can be applied, groups must check off various tests and rules – one of which relates to hybrid arbitration arrangements.

Labour law

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Abolition of guaranteed wages and holiday scheduling and other news from the summer amendment to the Labour Code

On 31 July 2024, the so-called summer amendment to the Labour Code was published in the Collection of Laws.[1] Most of the amendment's provisions came into force the very next day – 1 August 2024.

Some of the provisions of the summer amendment, in particular the possibility of self-scheduling working hours, were originally supposed to be included in the still-under-discussion Labour Code flexi-amendment meant to bring further substantive changes to Czech labour law. In the end, however, the Ministry of Labour and Social Affairs included self-scheduling in the summer amendment to facilitate their approval, though they aren't due to come into force until 1 January 2025.

Abolition of the guaranteed wage and adjustment of the guaranteed salary

The amendment did away with the entire regulation of guaranteed wages in the private sphere. Employers are now only required to ensure compliance with a single numerical criterion, i.e. the minimum wage, when setting remuneration. They no longer have to compulsorily classify employees into 8 categories according to the type of work they do in order to ensure the appropriate level of guaranteed pay is met. If you have a guaranteed wage regulated in, for example, the pay regulations, it is now possible and appropriate to review this regulation.

The administrative burden has therefore been reduced thanks to the amendment, but employers will not be able to avoid proper categorisation of all positions according to objective criteria as the equal pay regulation under EU Directive 2023/970 approaches.

In the salary sphere, the summer amendment simplified the regulation of the guaranteed salary by reducing the number of salary levels from eight to four.

1 The full text of the amendment is available HERE.

Minimum wage indexation mechanism

The amendment introduced a new way of determining the minimum wage. Currently, the minimum wage is set by government decree, and changes often occur just before the end of the calendar year. This makes the wage costs of employees around the minimum wage and the calculation mechanisms linked to the minimum wage unpredictable for employers.

The new indexation system should be more predictable. The government will approve the coefficient for calculating the minimum wage two years in advance. The coefficient will then be multiplied by a forecast of the average gross monthly wage in the national economy and the resulting minimum wage for the following year will be published by the MLSA by 30 September. The minimum wage for 2025 will thus be CZK 20,800 per month and CZK 124.40 per hour, according to the MLSA announcement.

Scheduling of working time by the employee

A new feature introduced into the Labour Code by the amendment from 2025 is the possibility to delegate the scheduling of working time to employees. Until now, the possibility of scheduling one's own working hours has only been available to employees working remotely, but employers will now be able to arrange this with any employee. They will need a written agreement setting out the details of how their working hours will be divided into shifts. The agreement on self-scheduling will be terminable by written agreement between the parties or by giving 15 days' written notice from the date of delivery.

However, even if employees schedule their own working hours, they must respect the maximum shift limit of twelve hours and observe the mandatory breaks. At the same time, the fixed or agreed weekly working time must be fulfilled.

Should an employer allow an employee to schedule his/her working time independently without an appropriate written agreement or violate other legal obligations related to the scheduling of working time by the employee, the employer may be subject to a new fine from the Labour Inspectorate of up to CZK 300,000.

Elimination of the obligation to establish a written holiday timetable

The area of holiday planning has also been simplified. According to the explanatory memorandum, the legislator has decided to eliminate the employer obligation to draw up a written holiday schedule for the whole year in advance every year, mainly in order to reduce the administrative burden. Another reason given is to avoid the common practice where the employer formally draws up a holiday timetable at the beginning of the year, but in practice does not follow it in determining holidays for various reasons (e.g. to change the number of hours worked).

Another change to the holiday arrangements is deletion of the rule that "holiday should normally be taken in whole". However, it is still the case that at least part of the holiday must be taken in whole after two weeks.

Note: the amendment doesn't change the employer obligation to notify the employee of the specific period of holiday at least 2 weeks in advance, or within a shorter period agreed with the employee.

Changes in collective bargaining

The amendment has also changed the process of negotiating a collective agreement in cases where an employer has more than one trade union. According to the previous regulation, the employer was obliged to negotiate a collective agreement with all trade unions in such cases, unless the trade unions agreed otherwise among themselves. In cases where the unions disagreed, there was a stalemate and a collective agreement could not be concluded.

The employer may now conclude a collective agreement with the trade union with the largest number of members in the event of disagreement between the trade unions. However, a collective agreement cannot be concluded if a majority of all employees disagree in writing. The latter may also determine with which trade union the employer is to conclude a collective agreement.

Conclusion

This Labour Code amendment, passed and immediately effective between the summer holidays, in addition to being overshadowed by the pending flexi-amendment, has somewhat escaped attention. However, a number of the useful changes that have been approved should be reflected in employers' practices. They should check whether they're unnecessarily using the abolished guaranteed wage, identify employees for whom self-scheduling of working hours would make sense and do away with the formal annual holiday plan. And also count on a minimum wage of CZK 20,400 for 2025.

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

The amendment Labour Code, which for the most part came into force on 1 August 2024, introduced major changes, for example, in the area of minimum and guaranteed wages. In addition, from 2025 it will do away with the compulsory annual holiday schedule and legalise the option of self-scheduling work for all employees with whom the employer has agreed.

VAT

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Changes to VAT registration from 2025: what you need to know

The VAT Act amendment scheduled to come into effect on 1 January 2025 (now after the second reading in the Chamber of Deputies) introduces changes to the rules for mandatory registration for small enterprises exceeding their turnover. The change will affect not only the way turnover is monitored, but also the deadline for meeting the registration obligation or the moment of becoming a taxpayer. It also opens up the possibility for small enterprises to benefit from tax exemptions in other EU Member States, provided they do not exceed the annual turnover limit of the Union or the limit set by the Member State in which they wish to benefit from the exemption.

Current rules

Currently, enterprises must track their turnover for the last 12 calendar months. If they reach a turnover of CZK 2,000,000 in this period, they are obliged to register for VAT within 15 days of the end of the month in which their turnover exceeded. They become a taxpayer with a delay (e.g. if they exceed their turnover at any time during January until March, unless they become a taxpayer for another reason earlier). Enterprises therefore do not have to subject their transactions to tax one or two months after exceeding their turnover.

New rules

The changes to the rules are based on EU law, specifically the transposition of Council Directive (EU) 2020/285, which concerns the special regime for small enterprises.

Turnover calculation method

The amendment introduces a change in the calculation of turnover from 12 consecutive calendar months to a calendar year. Certain exempt supplies or so-called "fictitious supplies" (typically gratuitous supplies, transfer of own goods from the domestic country to another Member State, etc.) will be included in the turnover.

Turnover limits for compulsory registration

The amendment sets two turnover thresholds that determine the point at which a taxable person becomes a VAT payer:

- The "original" limit of CZK 2,000,000 – after reaching it, the entrepreneur becomes a VAT payer from the first day of the following calendar year. However, he can voluntarily become a taxpayer as soon as the day immediately following the day of exceeding this limit, provided he registers within the statutory deadline (see below for more details).
- The "newly introduced" limit of CZK 2,536,500 (equivalent to the EU limit of EUR 100,000) – after reaching this higher limit, the entrepreneur immediately becomes a VAT payer on the following day.

Further tightening cannot be ruled out in the future – the EU Court of Justice confirmed in the case of the sale of real estate that the state may require VAT to be paid on transactions exceeding the turnover.

VAT regime before becoming a taxpayer

Until the taxable person becomes a taxable person, he is exempt from applying output VAT without the right to deduct it.

Compulsory payer registration

The registration application will now have to be submitted within 10 working days from the date of exceeding the relevant turnover. The deadline for compulsory registration of the taxpayer is thus significantly shortened. Failure to comply with the registration obligation may be sanctioned by a fine under § 247a of the Tax Code.

Special regime for small enterprises throughout the EU

EU small enterprises now have the opportunity to be exempt from VAT in other Member States, provided their annual turnover in the previous or current year does not exceed the EU-wide limit of EUR 100,000 or the threshold set by the Member State in which they wish to claim the exemption.

If enterprises decide to join the small enterprise scheme in another Member State, they will first have to register with the tax authorities in their country of establishment.

Once registered, they will be required to submit quarterly reports (notifications) on their EU-wide transactions. The reports will be important for tracking their annual EU turnover. If they exceed the turnover threshold, they will no longer be able to benefit from VAT exemptions in other Member States.

Special regime for small EU enterprises in the Czech Republic

Entrepreneurs from other EU Member States registered under the special regime for small enterprises will now be able to benefit from the Czech VAT exemption if their turnover in the Czech Republic does not exceed CZK 2 million per calendar year. Should they exceed the domestic or EU limit, the possibility of applying the tax exemption in the Czech Republic will end.

Special regime for small Czech Republic enterprises in the EU

Czech entrepreneurs registered under the special scheme for small enterprises will have to monitor whether their total turnover within the EU has exceeded CZK 2,536,500 (equivalent to EUR 100,000). If they exceed the limit, they would no longer be able to use the cross-border small enterprise scheme within the EU.

However, if the national turnover limit of CZK 2 million in the Czech Republic is not exceeded, they can remain a non-taxpayer at least in the Czech Republic.

Abuse of law as the main driver of change

The tax administration expects the new rules, among other things, to limit unfair practices abusing the existing time difference between the moment of exceeding the turnover and the actual creation of VAT payer status.

In practice, situations of abuse often occur, whether through a chain of purposefully established companies that continue to perform identical economic activities (with identical background and resources) as their predecessor, which would otherwise become a VAT payer and have to start paying tax (see, for example, Regional Court in Ostrava Judgment 22 Af 24/2022 - 97, where such a structure was [not yet definitively] described as an abuse of law), or through purposeful de-registrations and renewed VAT registrations.

An important milestone is the recent judgment of the Court of Justice of the EU in Case C-171/23, where the Court concluded that the creation of a new company and the use of a VAT exemption scheme originally applied to another company can be considered an abusive practice. The Court emphasises that EU law cannot be abused to obtain undue advantages and that it is necessary to ensure that tax strategies are consistent with its objectives. The judgment has a direct impact on enterprises that might be motivated to break the tax continuity of a previous company in order to avoid paying VAT, thus reinforcing the importance of transparency and fairness in the tax system.

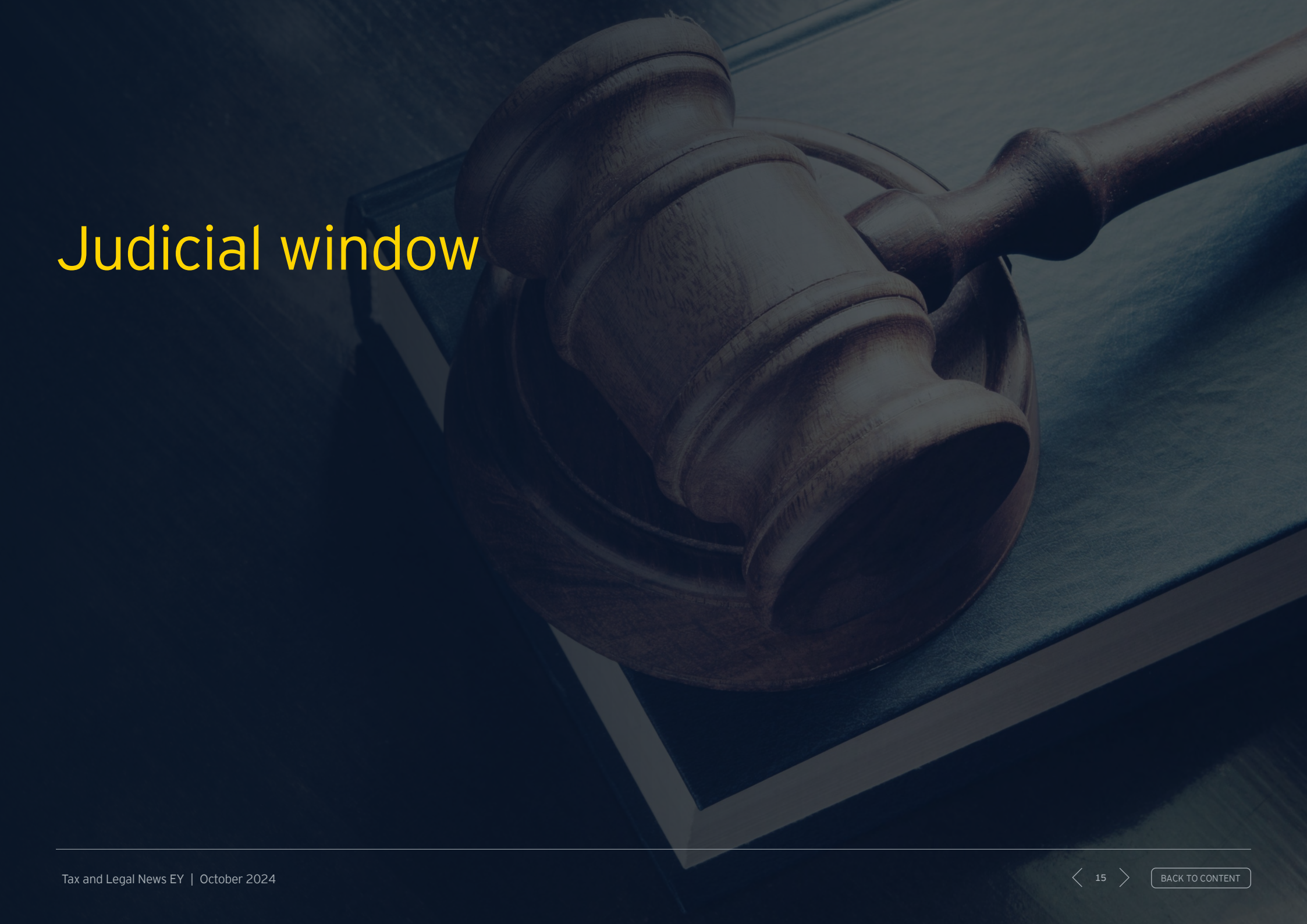
Conclusion

For small Czech entrepreneurs, the new rules will allow them to better plan their tax strategies and take advantage of the EU single market without having to worry about immediate VAT registration.

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

Small entrepreneurs have to prepare for a new method of tracking and calculating turnover, a shorter period for compulsory registration or a new moment of becoming a taxpayer. Due to abusive practices, the time for becoming a taxpayer is to be significantly shortened. Small enterprises in the EU will be able to benefit from VAT exemptions in other Member States.

Judicial window



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A Regional Court decision on the tax implications of a parent company's production start-up order

A Regional Court (RC) recently ruled in a dispute concerning a situation where a parent company had issued an instruction to start production of automotive components, on the basis of which the subsidiary was incurring the costs associated with the start of that production. In the tax authority's view, the Czech company should have been compensated for those costs, since the company in question, as a manufacturer with limited functions and risks, should not have borne the costs in question.

Background

In 2011, it was decided by the parent company that the Czech subsidiary would manufacture components for the automotive industry. As a result of this decision, the Czech company incurred significant costs to start the production and thus realised a loss in the period under review.

Subject of the dispute

The tax administrator pointed out that the parent company had not compensated the subsidiary, which was in the position of a contract manufacturer with limited functions and risks, for the costs of starting production, which it considered to be a breach of the arm's length principle.

The Czech company argued that there were no transactions with related parties in the sense of a contractual relationship during the tax year under review, but only costs related to the implementation of the new production. In addition, it argued that even an independent contract manufacturer would have invested in the start-up of production, which would then generate income corresponding to the arm's length principle.

The tax administrator, on the other hand, argued that although the OECD Directive considers start-up costs to be a legitimate business reason, they must always be assessed with respect to the assigned functions (limited, in this case). It also stressed that independent operators acting under their own entrepreneurial responsibility would not logically agree to a completely new production at the behest of their business partner unless they were compensated with adequate economic benefit.

The tax administrator further noted that the adjustment of transfer prices pursuant to § 23(7) of the Income Tax Act is made only for the purpose of adjusting the tax base and does not create any new liabilities between the related parties.

The disputed issue was therefore whether the parent company's order to start production and the related costs could be classified under § 23(7) of the Income Tax Act and whether the parent company was obliged to compensate the costs of starting production in the present case.

Decision of the RC

The RC ruled in favour of the Czech company and annulled the tax administrator's decision.

The RC held that start-up costs incurred in connection with the parent company's order to start the production in question cannot be considered a transaction between related parties within the meaning of § 23(7) of the Income Tax Act. The key argument of the court was that this was not a classic commercial transaction (contractual obligation) but a decision by the parent company to manage the business of the Czech company.

The court further held that the characteristic of related parties in the parent-subsidiary relationship is certainly that the parent company decides on the production direction of its subsidiary. The parent company did not receive any direct profit as a result of that decision, nor is there any indication that the conduct of the parent company now under consideration caused damage to the Czech company. At the same time, the rationality of the decision in question has not been questioned.

Finally, the RC specifically stated that the Czech company's loss was to be compensated not for the taxable period of the start-up phase of the new production, but only in subsequent periods in which sales to related parties were already taking place, in accordance with the arm's length principle.

Conclusion

Although the RC judgment represents, from our point of view, an interesting perspective on the issue of transfer pricing, the Supreme Administrative Court (SAC) has ruled in a similar manner in the past, in relation to the disposal of material when production ceases on the basis of a parent company's instruction[2].

The basic principle of arm's length is based on the assumption that transactions (prices) negotiated between related parties would be negotiated between unrelated parties in the ordinary course of business. Thus, an arm's length party can only be expected to enter into a given transaction (business arrangement) if it is guaranteed a return on its investment and, at the same time, the associated remuneration. However, both the tax administrator and the RC viewed the transaction in question only in isolation from the perspective of the commencement of the production in question. The same approach was taken by the tax administrator and the SAC in the aforementioned earlier judgment.

It will be interesting to see whether these decisions will provide a more general impetus for considering related party transactions in the broader context of an entity's entire transaction/business over a longer horizon than one year, both on the part of the tax administration and taxpayers.

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

The RC ruled that the parent company's order to start production and the associated costs cannot be considered a transaction between related parties, but only a business management of the Czech company, where the parent company decided on its production direction.

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

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- The OECD hosted a ceremony to mark the launch of the STTR MLI?
- A recent SAC decision highlights that assessing whether or not a license (or similar) fee should be included in the customs value of imported goods is a complex task, but one that is governed by relatively clear rules?
- The Government Decree on the amount of the general assessment base for 2023 and the conversion coefficient for the adjustment of the general assessment base for 2023 was published in the Collection of Laws?