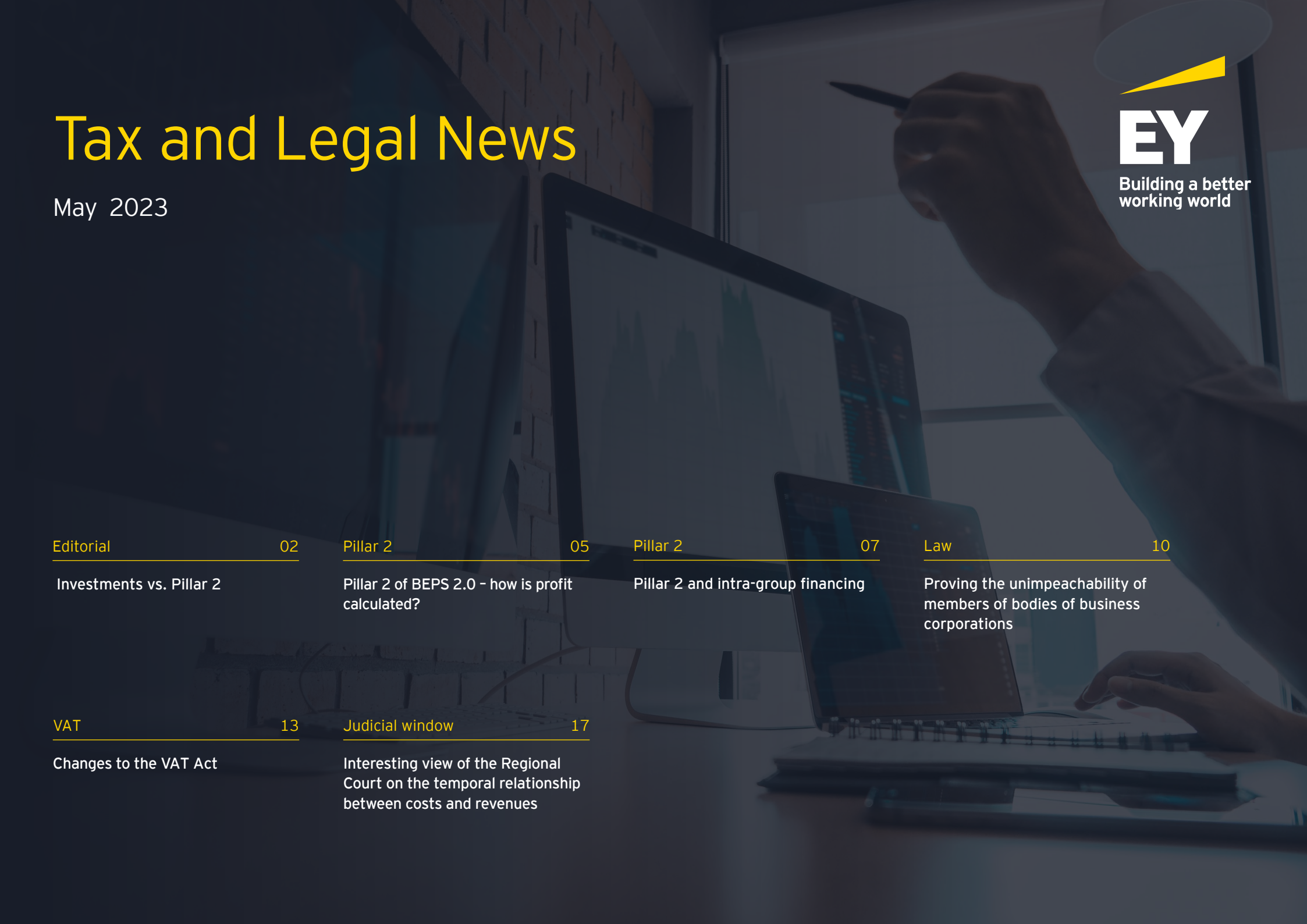
Tax and Legal News

May 2023



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Investments vs. Pillar 2

Gross domestic product fell in Q4, unemployment rose to almost 4%, energy prices and higher interest rates are slowing construction, holding back the real estate market and businesses, and new investment is not flowing into the Czech Republic.

This last phenomenon is due not only to the uncertain geopolitical situation in the region, rising inflation, wages, energy prices and the downturn in Germany, but also the not entirely competitive public support for new investments. This is not only in comparison with neighbouring countries, which, in addition to tax rebates, also offer cash subsidies for investment, job creation or land at preferential prices in functional industrial zones. Not only have traditional non-European competitors such as Turkey become involved in attracting investment, but more recently the example to follow, the USA, has as well. Their programs (including tax rebates) worth hundreds of billions of dollars in domestically produced green technologies (Inflation Reduction Act) and in the manufacturing and research of electrical components (Chips Act) are designed to attract manufacturing not only back from China but also from Europe, which many manufacturers are happy to hear. The European Union has already lodged an official protest over discrimination against European producers, though it seems not to have been successful.

The EU has responded with its Chip Act, which has been under discussion since last year, but is still going through the legislative process. Its future is unknown.

The current Czech government is also trying – the recently approved amendment to the Investment Incentives Act and the relevant implementing regulation should direct support to projects that "contribute to the Czech Republic's goals of energy self-sufficiency or, for example, strengthening the European semiconductor ecosystem.". On the other hand, the same amendment tightens the condition of higher added value (very simply, the requirement to spend funds in the field of research and development) to most of the Czech Republic. Moreover, even if all the specific conditions are met, the granting of the incentive may be vetoed by some of the ministries commenting on the application. Some have had such bad experiences in the past, e.g. with the Ministry of Finance, which does not seem to be a great supporter in general of investment promotion.

But even if the project successfully meets even the most stringent criteria and passes the rigorous assessment of all the relevant institutions, a new pitfall awaits investors: the spectre of Pillar 2. This set of rules, originating in an initiative against tax-aggressive structures poetically called Base Erosion and Profit Shifting (BEPS), simply seeks to ensure an effective tax rate of at least 15% in each jurisdiction. However, this may result in a company with

an investment supported by a tax rebate reducing its tax liability on one line thanks to the investment incentive and having to increase it again on the next line through the Pillar 2 mechanism. Although the designers of Pillar 2 are aware that this mechanism catches not only situations where tax avoidance has actually taken place, but also legitimate support allowed by EU regional aid rules, they do not pay much attention to this. In addition to the gradually decreasing substantive carve-out, which can positively affect the effective tax rate of companies with employees and productive assets, they glibly recommend that states replace tax rebates with other public support instruments that will not reduce the effective tax rate.

Pillar 2 may thus have a major impact on the few remaining pro-growth (or anti-decline) tax instruments, i.e. investment incentives and the R&D deduction. Significant changes to the current system would be necessary if the state were to maintain support for new investment and R&D and keep pace with the competition. While some EU Member States are actively modifying the existing rules and replacing tax rebates with rebates on other levies or transforming them into a so-called qualified refundable tax credit (which is booked to income and thus does not affect the effective tax rate), in this country the situation is still quiet.

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Pillar 2

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Pillar 2 of BEPS 2.0 – how is profit calculated?

Continuing the series on the BEPS 2.0 - Pillar 2 initiative, this time we will focus on the calculation of profit or loss under the GloBE rules (Global Anti-Base Erosion rules) - the EU directive speaks of the qualifying income or loss. The aim of this article is not to give you a detailed procedure for calculating the gain under the GloBE rules, as the rules are extremely complex (hence the use of the word e.g. or in particular so many times in this article), but rather to highlight the basic significant items and rules.

The starting point is the entity's accounting profit (or loss) for the accounting period before consolidation adjustments, as reported under the accounting standard under which the ultimate parent entity consolidates. In practice, this will most often be International Financial Reporting Standards (IFRS). Under certain conditions, the accounting profit (or loss) reported under another acceptable accounting standard, such as CAS, may be used, but permanent differences arising from the application of another accounting standard in excess of EUR 1 million will still need to be adjusted.

The accounting profit or loss will be adjusted for specific items. These include:

- tax expense,
- dividends arising from non-portfolio holdings,
- capital gains or losses on non-portfolio holdings (capital gains include changes in fair value or gains or losses on disposals including related income or expenses),
- gains or losses on the remeasurement of property, plant and equipment to fair value (including the related tax charge) recognised in equity,
- gains or losses arising from changes in the exchange rate between the functional currency for accounting purposes and the functional currency for tax reporting purposes,
- so-called 'policy disallowed expenses', e.g. illegal payments in the form of bribes and illegal commissions, payments of fines or penalties,

- changes in equity resulting from corrections of errors in the determination of accounting profit or loss in previous accounting periods or from a change in the accounting method,

- certain pension costs.

Other adjustments to the accounting profit or loss may relate, for example, to intragroup transfers of assets (particularly if they are not negotiated in accordance with arm's length principles or in connection with a reorganisation such as merger) or to intragroup financing. In certain cases, the EU Directive offers the possibility to elect the regime for including income or gains in qualifying income (e.g. in the case of share-based remuneration expenses). In addition, each of the above categories has its own definition, which may be different from the definition we use for tax purposes.

Accounting profits or losses of permanent establishments are generally allocated to the jurisdictions in which the permanent establishment is located - a standard issue for tax purposes that may be a completely new one for accounting (IFRS) purposes. Special rules apply to tax transparent entities in different situations. When we add the transitional provisions where, for example, intra-group transactions after 30 November 2021 need to be monitored, the calculation of qualifying income will be challenging, and the result may be surprising. The ability to elect regime for certain items introduces an element of great uncertainty into the process and the need to make the right decision based on accurate numbers and reasonable estimates.

We intend to pay more attention to this area in our tax reports and alerts.

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

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Pillar 2 and intra-group financing

This time, in our occasional feature on selected topics related to Pillar 2, we focus on the special limitation for intra--group financing.

This limitation is contained in Article 16(8) of the Directive on ensuring a global minimum level of taxation of multinational enterprise groups (the "P2 Directive"). What does this rule say?

In simple terms, it says that costs related to intra-group financing are not taken into account for a constituent entity if:

a) the constituent entity is located in a low-tax jurisdiction or in a jurisdiction that would have been low-taxed if the expense had not been incurred by the constituent entity;

b) such intra-group financing will increase the amount of expenses taken into account in the calculation of the qualifying income/loss of that constituent entity without resulting in a commensurate increase in the taxable income of the counterparty;

c) the counterparty is located in a jurisdiction that is not a low-tax jurisdiction or in a jurisdiction that would not have been low-taxed if the counterparty had not accrued the income relating to the costs in question.

Complicated reading. However, one would expect that the likely principle behind this restriction is to prevent intra-group financial structures that would seek to increase the effective tax rate (ETR) in a jurisdiction with an ETR below the 15% threshold by reducing the member entity's qualifying income/loss without increasing the counterparty's taxable income.

In this regard, the Commentary states that a payment should not be treated as increasing the counterparty's taxable income if it qualifies for an exclusion, exemption, credit or other benefit under local law, whereby the amount of that benefit is calculated by reference to the amount of the payment received. As an example of such a situation, the Commentary identifies a counterparty that has unused excess interest capacity from prior years (i.e., interest expense disallowed due to an excess over the interest deductibility limit derived as a percentage of earnings) that it does not otherwise expect to use and that capacity covers income arising from intra-group financing provided to a member entity in a low-tax jurisdiction.

Given its complicated and not entirely unambiguous formulations, this limitation is likely to cause us some trouble in practice.

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

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Proving the unimpeachability of members of bodies of business corporations

As of 15 January 2023, it is no longer necessary to submit to the registry court or the notary performing direct registration in the Commercial Register an extract of the registered person from the criminal register or similar records of a foreign state. The submission of an affidavit by the person enrolled is sufficient to prove his/her unimpeachability. As of 1 July 2023, courts and notaries will verify the eligibility of a registered person to hold office through a newly established register of disqualified persons. The register will be non-public, with the possibility for the person concerned to electronically request the provision of the information recorded in the register.

No more trips around the world to prove unimpeachability

The amendment to the Act on Public Registers of Legal Entities and Natural Persons and on the Registration of Trusts ("PRA") is effective from 15 January 2023, and brings a welcome change in the method of proving the unimpeachability of selected persons entered in the Commercial Register (e.g. the managing director of a limited liability company or a member of the board of directors or management board of a joint-stock company) and which will make this process faster and easier.

In order to prove good character, before the change of the Criminal Code it was necessary to submit to the registry court or notary an extract of the registered person from the Czech Criminal Register or a similar register of a foreign state depending on his/her citizenship or place of permanent residence. For Czech citizens, this process did not entail any major difficulties, as in most cases the court or the notary carrying out the direct registration obtained the extract themselves. However, for foreign persons, especially non-EU citizens, obtaining an extract was very time-consuming and often involved a personal visit to the authorities in their home country. This is now a thing of the past and the submission of an affidavit of the enrolled person is now sufficient to prove his or her unimpeachability. In it, the person to be enrolled shall state that he/she is not prevented from exercising the functions of a member of an elected body and that he/she meets the condition of unimpeachability. The substitution of an affidavit of good character for an extract from the criminal register was possible under the previous legislation only if the relevant State did not issue an extract from the criminal register.

If the affidavit of unimpeachability contains false information, that person shall be regarded as if he or she had never been a member of the institution. In addition, the provision of false information may be classified as a criminal offence.

The definition of unimpeachability is also changing and a disqualification register is being introduced

In connection with the Union's Directive on the use of digital tools and procedures in company law ("Digitisation Directive"), certain provisions of the Business Corporations Act ("BCA") will also be amended with effect from 1 July 2023. The BCA amendment, together with other changes to related legislation, is intended to strengthen the possibility of using electronic identification and remote communication in the establishment of business corporations. The amendments include, among other things, a new definition of the unimpeachability of members of elected bodies of business corporations and the introduction of a register of disqualified persons.

The requirements for unimpeachability will be newly set out directly in the BCA. The list of criminal offences that will constitute an obstacle to the performance of the duties of a member of an elected body will be extended. Unlike the previous arrangement, it will not only comprise offences in connection with the conduct of business, but also offences which may be relevant to the assessment of the suitability of the candidate and the guarantees provided by him/her for the performance of his/her duties. These will include, inter alia, tax, fee or foreign exchange offences, offences of breach of duty in the management of foreign property and other offences of a property and economic nature.

In accordance with the Digitisation Directive, individual EU Member States will be obliged to establish an information system on persons excluded from serving as a member of an elected body of a commercial corporation. This register will be part of a so-called European central platform, which aims to link the individual Member States and further facilitate electronic identification. According to the BCA, the register will include, for example, persons who have been banned from acting or who have been convicted of a criminal offence constituting an obstacle to the performance of their duties as a member of an elected body. According to the explanatory memorandum to the BCA amendment, notaries and courts will have access to the Register of Disqualified Persons, which will automatically verify the eligibility of the registered person to perform the function. In addition, data on disqualified persons will be shared between Member States. The explanatory memorandum to the amendment also states that any person will be able to request an extract of the data recorded or a confirmation that he or she is not on the register. The data will be retained for ten years from the date of cessation of the obstacle to the exercise of the function.

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

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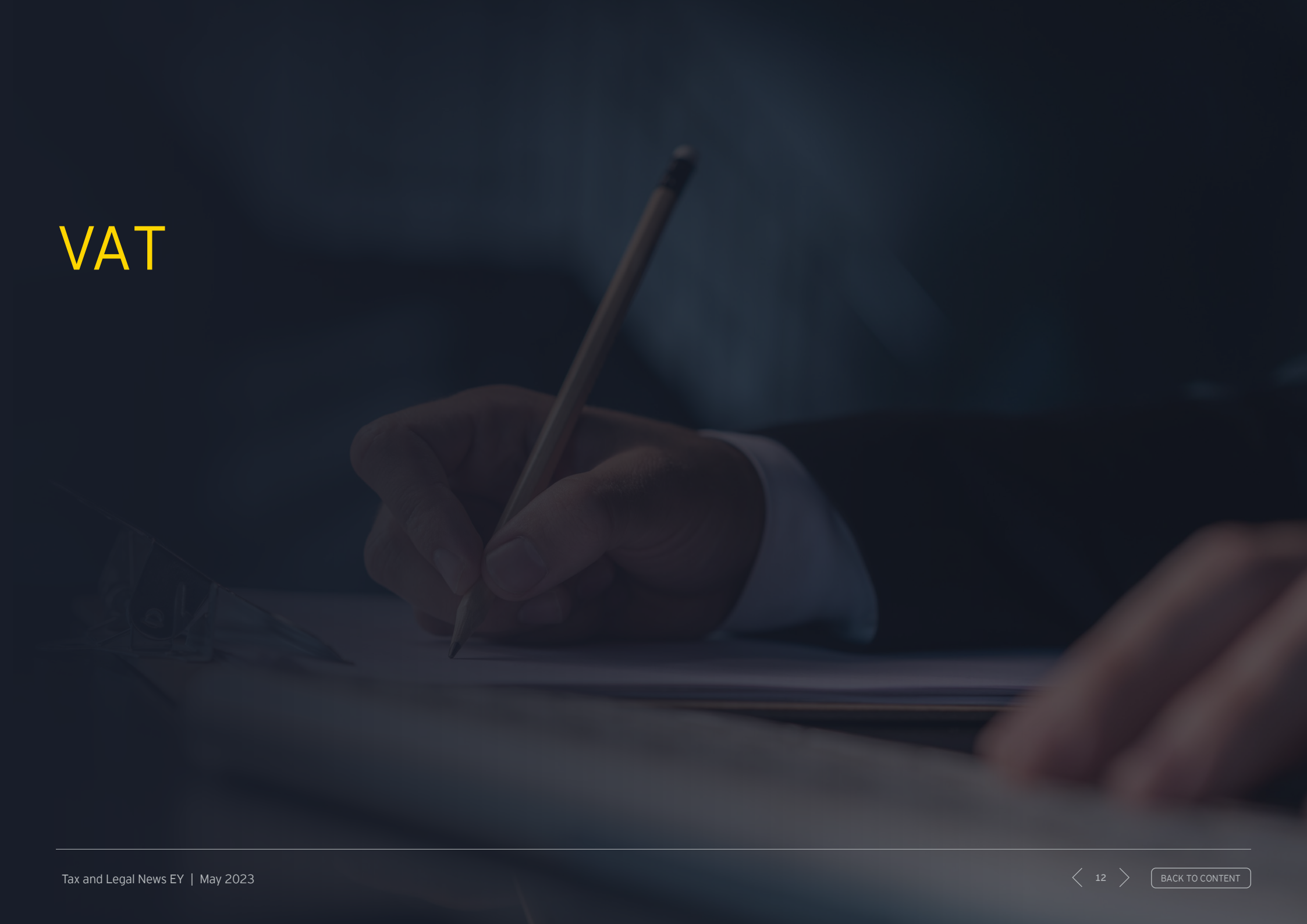
VAT



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Changes to the VAT Act

In today's article, we draw your attention to the forthcoming amendment to the VAT Act No. 284/2021 Coll., in connection with the adoption of the new Building Act[1]. The amendment mainly concerns the construction industry and the sale and rental of real estate, specifically amending the provisions of § 48, § 56 and § 56a of the VAT Act. At first glance, the inconspicuous changes raise several questions. However, the main question is whether anything will change at all.

Below we summarise the main changes to come and some contentious points in their interpretation:

- The term "building approval" will be deleted from all provisions of the VAT Act. The institution of the approval of the building permit will be completely abolished by the new Building Act and only the approval decision will remain. The wording of the VAT Act will only be adapted to the terminology of the new Building Act and nothing will change in substance, as confirmed by the explanatory memorandum to the amendment. According to the transitional provisions, already issued approvals are considered as approval decisions under the new regulation.
- All references in the VAT Act to the regulations governing the Land Registry ("LR") will be replaced by references to the new Building Act. This change concerns the definition of the construction of an apartment building, a single-family house and a living space. The amendment also includes a two-year transitional provision for single-family houses, the aim of which is to ensure that the new definition of a single-family house does not lead to "immediate changes in the tax rate for the provision of construction or assembly work associated with construction already underway and for the supply of single-family houses which are considered for VAT purposes to be a building for social housing, and for the provision of construction or assembly work for repairs and other structural alterations already underway on

1 Act No. 183/2006 Coll. on zoning and building regulations will be replaced by Act No. 283/2021 Coll., the Building Act. Decree No. 501/2006 Coll. will be repealed.

completed single-family houses". The explanatory memorandum to the VAT Act amendment therefore directly states that some houses that meet the current definition of a single-family house will no longer meet this definition under the new legislation (in other words, the new definition will comprise a smaller set of houses). The amendment does not contain any transitional provisions for apartment buildings.

- Looking at the literal wording of the old and new definitions of single-family houses and apartment buildings[2] we can discern two changes:

1) For the definition of a single-family house, the addendum "or a third story set back from the exterior face of the exterior wall of the building oriented toward the street line by at least 2 feet" has been added. With this change, it is clear that the new definition of a single-family house is a broader set as it allows for a third floor in addition to the existing elements. A single-family house meeting the conditions of the old definition will also meet the new one. It is therefore unclear what situations the transitional provision is aimed at, and it appears to be an empty set. The Chamber of Tax Advisors of the Czech Republic made a submission to the Coordination Committee No. 606/03.05.23 – Controversial provisions of the VAT Act effective from 1 July 2023. This submission proposes that the Financial Administration confirm that "the set of cases to which the transitional provisions apply or may apply is zero". It is expected to be discussed in June this year.

2) Furthermore, for both definitions, the phrase "meets the requirements for permanent housing and is intended for that purpose" has been replaced by "serves as housing". At first glance, it may seem that the building-legal designation for housing (entry in the land register as a single-family house/apartment building) will no longer be decisive, but it will be relevant whether or not the majority of the building is actually used for housing at the time. This change has potentially two levels of impact where confusion in taxation may arise:

i. buildings registered in the land register with an error, e.g. an approved single-family house registered in the land register as a cottage due to an error or time delay in registration,

ii. buildings correctly registered in the land register as buildings not used for housing, but actually used for housing, e.g. a building for family recreation is actually used for housing.

Draft Information of the GFD on the application of the VAT Act to immovable property from 1 July 2023 (now in the comment procedure, see our recent Alert) states that in the case of apartment buildings and single-family houses, it is necessary for the land register to indicate the type of use: apartment building /single-family house. If such an indication of the use of the building is not given in the land register, the building is considered not to meet the conditions for a single-family house/ apartment building and will not be considered a building for housing

2 Definitions according to the cadastral decree and the new Building Act
Apartment building [definition according to Decree No. 501/2006 Coll.] "A building for residential use in which more than half of the floor area meets the requirements for permanent housing and is designed for that purpose".
Apartment building – new [definition according to the new Building Act] "a building for housing in which more than half of the floor area is used for housing".
Single-family house [definition according to Decree No. 501/2006 Coll.] "A building for dwelling in which more than half of the floor area meets the requirements for permanent family housing and is designed for that purpose; a single-family house may have no more than three separate dwellings, no more than two floors above ground and one underground floor and an attic".
Single-family house – new [definition according to the new Building Act, § 13] "a building for residential purposes in which more than half of the floor area is used for residential purposes and which has not more than three separate dwellings, not more than two storeys above ground and one underground storey and an attic, or a third storey set back from the outer face of the external wall of the building oriented towards the street line by at least 2 metres".

from the point of view of the VAT Act. This opinion of the Financial Administration is also stated in the current GFD information on real estate. This maintains the same approach whereby the supplier can rely in good faith on the land register.

However, it is questionable whether taxpayers can proceed in another way if they know that the entry in the land register does not correspond to reality [options (i) and (ii) above] and taxation according to reality is more advantageous. The submitters of 606/03.05.23 deal with situation (i) and propose that the actual building-legal designation (i.e. for which type of building a valid approval decision has been issued) should take precedence over the information in the land register. Whether such an interpretation will be accepted by the Financial Administration will be clear in June after the discussion of the submission with the Financial Administration. Situation (ii) is not directly addressed in the submission and the Financial Administration does not need to comment on it. Although the wording of the amendment appears to offer this possibility, it was certainly not the intention of the legislator and such an interpretation cannot be relied upon.

In conclusion, the amendment to the VAT Act effective from 1 July 2023 does not seem to bring anything new for VAT payers. Nevertheless, it will be necessary to wait for the opinion of the GFD on Coordination Committee submission 606/03.05.23, which will eventually confirm the invalidity of the two-year transitional provisions for single-family houses and the GFD's approach to the discrepancies between the data in the land register and the actual construction-legal designation of a building. At the same time, in addition to the amendment itself, close attention should be paid to the forthcoming GFD Information on Real Estate, which will reflect the latest concluded Coordination Committee submissions and also the current case law.

Additional note: Based on the amendment by the Senate of the Czech Republic, the effect of the VAT amendment will be postponed to January 1, 2024, in connection with the postponement of the effectiveness of the amendment to the Construction Act itself (more here).

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

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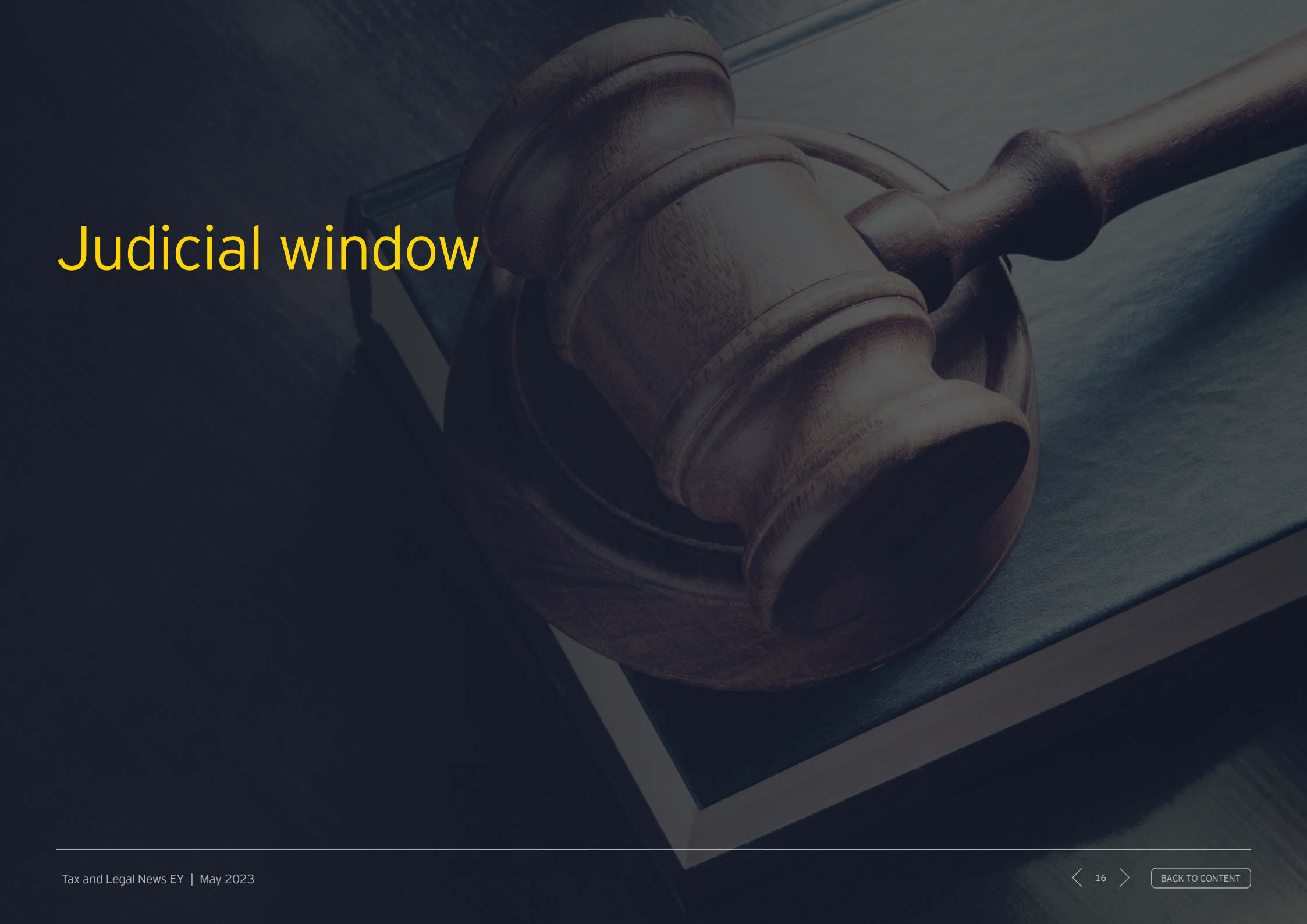
Judicial window



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Interesting view of the Regional Court on the temporal relationship between costs and revenues

In this issue, we present an interesting Regional Court in Brno judgment concerning a dispute regarding the tax deductibility of selected cost items primarily in the context of the temporal relationship of costs and revenues (the period ending in March 2011 was addressed).

Contentious areas

According to the tax administrator, the company incorrectly accounted for and, as a result, wrongly claimed expenses (or did not include income) in the following three main areas:

- failure to take into account the proceeds of an outstanding loan,
- discretionary employee bonuses,
- work in progress in the form of construction work.

Loan proceeds

The basis of the first substantive dispute is the accounting for interest on a loan made by the company to a Ukrainian company. The company has already made a 50% provision for this loan at the end of the previous tax year and a 100% provision at the end of the tax year under review (ending 31 March 2011). This loan matured during the audit period on 31 December 2010. The company did not receive the principal and, as of January 2011, it stopped including the agreed interest on this loan in its assets/expenses, as it considers that a purely imaginary income resulting only from the application of accounting rules should not be taxable.

The court disagreed with this approach. It held that the company was entitled to the agreed interest even after the maturity of the loan, was therefore obliged to include it in its accounts as an asset and it was taxable income. The court further found that the company accounted for the agreed interest in such a way that it did not relate its non-inclusion in the assets to the uncollectibility of the receivable at all – it accounted for it in full until 31 December 2010, though it recorded only 50% of the principal, and then in a zero amount, although it did not write off the principal in full until 31 March 2011. Moreover, the company did not provide any evidence

of the uncollectibility of the claim. On the contrary, the acknowledgement of debt signed with the Ukrainian debtor in 2012 indicated that their contractual relationship and the obligations associated with it continued.

Employee bonuses

In the 2010/2011 financial year, the company applied the cost of deemed bonuses for employees holding shares. In this context, the tax administrator examined, in particular, the wage regulation for employee bonuses from 2009. It is silent on the remuneration of shareholders directly, but in the annex "Conditions for granting annual bonuses", it regulates the annual employee bonus. In part of this annex, the wage regulation then states: *"Payment of annual bonuses (additional payments) is subject to an audit of the financial results of the fiscal year for which the annual bonus is granted"* and *"The annual bonus is not an entitlement component of the salary". In addition, the company submitted a document entitled "Determination of the amount for the annual employee bonus"* dated 25 March 2011, in which the company CEO, on the proposal of the CFO, approved, inter alia, the amount in question as a bonus for employees who contributed the most to the achievement of the 2010 financial result, with the proviso that this bonus would be due to employees who were holders of registered shares as of 31 March 2011.

There was agreement between the parties that the wage regulations were silent on the annual bonus for employees holding shares, or even spoke of the annual bonus being a non-cash component of pay. However, the company considered that the CEO, who had approved it in a decision of 25 March 2011, had added that entitlement.

The court disagreed. It identified as determinative the text of the wage regulation, according to which annual bonus is not an entitlement component of pay. It agreed that a non-payroll component may become an entitlement component by the employer's decision, however the CEO's decision is compounded by the fact that the text of the document in question states: *"For the annual bonuses of the employees who contributed most to the economic result for the fiscal year 2010, I am setting the amount of funds in the amount of...."*. In the court's view, the word "most" implies that only certain employees holding more shares than others would be entitled to the bonus, while the very next sentence says: *"This bonus will accrue to employees who are holders of registered shares as of 31 March 2011 ..."*. According to the court, it cannot be inferred from this document that the CEO had established any (and which) employees' entitlement to an annual bonus. According to the court, a company cannot be allowed to deduct that amount from its tax base as a future expense simply on the basis of a lump sum promise of the total amount it intends to pay its employees in bonuses. If the recipients of the bonuses are not identified by name in the CEO's decision and the amounts determined for them are not fixed and unchangeable, then there can be no civil claim by specific employees.

Finally, the company argued that if the tax administrator's reasoning regarding the accounting for annual employee bonuses is correct and the company should have accounted for the bonuses claimed in this tax year only in the following tax year, then "in return" the tax administrator should take into account the bonuses incorrectly claimed in the previous tax year now. Neither the tax administrator nor the court agreed with this procedure. According to the court, the situation could not be resolved by the company claiming the same expense, which had reduced its tax base in the previous tax year, repeatedly (author's note – the previous tax year was probably already closed).

For the sake of completeness, it should be noted that the judgment also mentions that the annual bonuses for employees holding shares were treated by the tax authorities as a hidden dividend, the future payment of which the company was not entitled to include in its tax base in the audited period under any circumstances. However, this aspect is not further analysed in the judgment, as the company probably did not object to it in the application.

Expenditure on work in progress

The main issue addressed was the extent to which it was plausible that the company, as a general contractor, invoiced its customer (the investor in the construction) for work that it had not yet taken over from its subcontractors, or work that those subcontractors had not yet actually carried out, and on that basis claimed the costs of that subcontracted work in the tax year in question.

The court acknowledged that the company was in a difficult situation and had only three options in the situation. First, to reduce the tax base in the tax year in question by the cost of the subcontracts not yet realised, as it had done. However, it then raised doubts as to whether the investor would actually reimburse it for the work not carried out. Secondly, it could reduce its tax base in the following tax year when it actually carried out the work. However, since it was not the removal of defects and deficiencies in the work, it would probably again raise reasonable doubts that it had carried out the work for free for the investor (it could not even declare the corresponding income in that tax year). Finally, it could have foregone the reduction in the tax base, which certainly did not seem fair to it if it had actually incurred the claimed costs and earned income on the basis of them.

According to the court, the company should, for example, have adapted the content of the contractual documentation or at least the handover protocols to this unusual situation, so that it was clear that work that had not yet been carried out was being handed over and paid for.

The court explicitly asked whether subcontracting costs had actually been incurred in the tax year in question if the subcontractor had not yet even fulfilled its obligation to carry out the work to which it had contractually committed the company. It notes, however, that it was not necessary to answer that question in the present case. Even if the court were to accept that the company had "reasonably foreseen" that it would incur an obligation to pay for a subcontract that had not yet been carried out (for example, because the subcontractor had already started some preparatory work), it still did not bear the burden of proving in the present case that there was any revenue corresponding to that obligation in the tax year in question.

A cassation complaint has been filed, so let's see what the Supreme Administrative Court has to say on these interesting matters.

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

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

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Did you know:

- Applications for a domestic VAT refund for 2022 for persons established outside the EU may be submitted until 30 June 2023?
- Changes in public procurement are coming soon?
- EY has published information about what the Whistle-blower Protection Act entails?
- The European Parliament approved a Carbon Border Adjustment Mechanism?
- The Supreme Administrative Court confirmed that land sold by a developer is considered goods for VAT purposes and its sale is not excluded from the coefficient?
- We are preparing an accounting and tax webinar on the new Accounting Act, which will take place on 23 May?
- We are preparing a tax, accounting and legal primer for technology and other start-ups, which will be held on 22 May?
- We are preparing a webinar on tax audit topics, this time focusing on transfer pricing – the event will take place on 16 May?