Tax and Legal News

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This year's tax gifts

The year's last editorial before Christmas always leads to the usual "what have they given us again", what else can we expect in the New Year, and culminates with the obligatory wish that we all carry on in good health.

Of course, we'll survive. We always do. Plus, this year's going to be a boring one. So, I'm lighting the first advent candle and opening a (second) bottle, and let's dive in!

Just a few small items are currently in the legislative process, primarily trying to fix what Santa Claus didn't catch last year – benefits and stock plans. But it was a toy that kept us all entertained for a whole year (though some of us didn't want to play anymore) and didn't immediately end up in a corner on Boxing Day, which was awesome. That's a must have. Then the VAT amendment, but without the traditional adrenaline rush of resetting all the systems to the new rates on New Year's Eve.

And let's not forget that this year we still have a number of beautiful gifts from previous years tucked under the tree. For example, the abolition of the unlimited exemption for sales of securities and shares from 1 January 2025. And then lots of gifts without a spark of surprise in children's eyes, but in the spirit of "oh, Mommy, look, I got a nice sweater". They're kind of like those prearranged, pre-rehearsed adult gifts. For example, the carbon tariff (CBAM), deforestation (EUDR), the top-up tax (Pillar 2) and related reporting. We know about them and can finally start using them. So don't forget them!

It seems that Santa Claus was busier abroad this year, and that's why he gave us a bit of a break. He gave a lot of presents to our neighbours in Slovakia. Financial transaction tax, increase in income tax rate for large corporations, increase in VAT rates, sectoral taxes, higher insurance premiums. Then the Slovaks will also have to pay a tax on sugar (or sweetened drinks) from the new year. And higher taxation on tobacco products. A. C. Pigou, the pioneer of the taxation of negative externalities, is also surely rejoicing at this gift.

Even less joy was brought by the UK gifts, especially in the form of a further extension of the already high inheritance tax, this time targeting agricultural land. Following the example of the Czech Republic, in November British farmers also went to the centre of the British capital to protest, of course with the necessary equipment. The UK has not been slow to collect existing taxes efficiently and consistently. Harry Potter (or rather his shadow taxpayer Rupert Grint) has to pay £1.8 million in back taxes after losing a battle with the HMRC (he has already lost £1 million in a case in another period). He and his tax and legal representatives waved their magic wands as hard as they could, but it was no use. The tax authorities insisted on taxing his income at a marginal rate of 52%, even though it was formally generated by a company of which he was a 100% shareholder. This capital income would only be subject to a 10% tax. The Czech tax system does not recognize the concept of corporate vs. personal income in the case of corporations operating only through a 100% shareholder. So far. This gift will also arrive in due course.

The very wealthy (today nicely referred to as "ultra-high-net-worth individuals") will also live to see it. G20 leaders promised them a proper fair tax in Rio de Janeiro at the end of November. Meanwhile, robots and AI are on the chopping block, because it's obviously a bigger nut for tax theorists to tax it all fairly (but they've only been working on it since 2017, so let's give them time). And we more down-to-earth "?-net-worth individuals" are still looking for the promised gift of the recodification of Czech accounting and related tax regulations. I think we'll be able to look forward to a few more Christmases.

If you wanted to add something to your wish list for Santa Claus, know that this year the communication will be two-way. The General Financial Directorate has launched the so-called Tax Echo (nudge letters), which is a personalised letter sent to taxpayers when a discrepancy in their tax liability is identified based on available data. Innovative, inspired by modern behavioural approaches. So take a good look under the tree to see if there's a letter left lying around that might be a bigger nuisance.

To all our readers (over 5,500 of you – thank you very much for that!), we wish you, as always "Happy Holidays!"

PS: If you're struggling to choose a gift for your similarly tax-law-and-accounting-impaired loved ones, give them the option of regularly subscribing to our newsletter HERE (let's have at least twice as many of us here next year).

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Transactions involving transfer of employees? You need to harmonise the pay conditions of all employees immediately after the transition

In its judgment in Case No. 21 Cdo 2559/2023, the Czech Supreme Court dealt with the question of whether the transfer of rights and obligations under labour law relations establishes a justifiable reason for the different treatment of transferred employees by the transferee employer in the form of their classification in a more favourable grade and salary bracket compared to other employees of the same employer.

What did the employee ask for?

The employee, a social services worker, sued her former employer for breach of the principle of equal treatment. She sought an additional salary up to the amount paid by the employer to other employees in the same position. These higher-paid employees were transferred to the employer as a result of the automatic transfer of rights and obligations under an employment relationship that occurred when two state organisations merged. They had less experience than the applicant employees, but were classified in a higher grade and bracket. According to the rules laid down in its internal rules, the employer did not take into account the creditable experience of existing employees, whereas it followed the standard rules for the employees taken over and took the creditable experience into account.

What do the employer and the CJEU say?

The employer argued that it had to apply the original rules to the transferred employees even after the transfer, because the transfer of rights and obligations "under the Labour Code must not be a reason to worsen the salary situation of the transferred employees." The Labour Code is based on EU Directive 2001/23 (on the preservation of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses). Therefore, in accordance with the principles of the Directive and normal practice, the employer took over the comparable employees with the terms and conditions that applied to them at their former employer, including the pay regulations, and did not change their terms and conditions after the transfer. The unequal treatment of the transferred employees compared with the existing employees was thus, in the employer's view, based on these justifiable grounds.

As the CJEU has repeatedly ruled (for example, judgments C 336/15 or C 317/18), Directive 2001/23 seeks to ensure that employees' rights are preserved in the event of a change of employer by allowing them to continue their employment with the new employer on the same terms as those agreed with the transferor. The aim of the Directive is to guarantee, as far as possible, the continuation of employment contracts or employment relationships without change with the transferee in order to prevent the employees concerned from being disadvantaged solely as a result of the transfer.

How do the Czech courts see the rights of employees during the transition?

Both the court of first instance and the court of appeal agreed with the employee that her employer had treated her unequally.

The employer appealed to the Supreme Court, which also ruled against it, relying on the employer's duty to ensure equal treatment of all employees. It recapitulated previous case law that the principle of equal treatment guarantees equal rights to employees in the same or a comparable position and implies a requirement that the employer's internal rules or practices do not unreasonably favour or disadvantage employees over other comparable employees. According to the established case law of the Supreme Court, the principle of equal treatment is violated if the difference in treatment has no objective and legitimate justification.

Pursuant to § 338 of the Labour Code, in the event of a transfer of an employer's activities or other legal reason, the rights and obligations under the employment relationship are transferred in full to the transferee employer; the rights and obligations under the collective agreement are transferred to the transferee employer for the duration of the collective agreement, but no longer than until the end of the following calendar year.

According to the Supreme Court, the new employer assumes those rights and obligations in the quality and with the features that characterised the original employer, including the conditions under which the agreed type of work is performed. Only the employer changes; the actual content of the employment relationship remains unaffected. The employment relationship of the transferred employees shall continue to be governed, as before, by the employment and other contracts of these employees, by valid and effective collective agreements binding on the original employer, and by the internal regulations of the original employer.

Can the transferee employer change the terms and conditions of employees after the transition?

According to the Supreme Court's ruling, the above rules do not mean the transferee employer cannot change the transferee employees' employment terms and conditions in the future.

From the moment of the transfer, the transferee employer is entitled – within the limits laid down by law, other legal regulations or the provisions of a collective agreement or individual contract (agreement) – to unilaterally change the working conditions of transferred employees, irrespective of their previous arrangement. It may therefore also amend or repeal an internal regulation adopted by the original employer. However, the employer is only entitled to change the agreed terms and conditions of employment from the individual contracts (agreements) adopted by the employee by agreement with the employee. The rights under the collective agreement concluded by the original employer must then be granted to the employees for the duration of the collective agreement, but no longer than the end of the following calendar year.

"The legislation on the transfer of rights and obligations under employment law does not provide for any exceptions to the obligation to ensure equal treatment of all employees for the transferee employer. Except for the period of time during which the transferee employer is bound by the rights and obligations under the collective agreement, it does not allow for the possibility of treating the transferee employees differently from its other employees."

The employer thus has to standardise the terms and conditions? By when?

From the above, the Supreme Court concluded that, after the transfer of rights and obligations under the employment relationship has taken effect, the transferee employer is obliged to take measures to eliminate unjustifiable inequalities in the area of working conditions and remuneration for work resulting from the different setting of rights and obligations of the transferee employees on the one hand and other employees of the same employer on the other. It must do so "within a reasonable time."

The length of reasonable time is not regulated by the Labour Code. The Supreme Court held that within two months after the transfer, the employee may terminate the employment relationship due to a substantial deterioration in working conditions (with the right to severance pay). Therefore, according to the court, the employee usually learns about the circumstances that mean such a deterioration earlier, and in such a way that he or she can consider terminating the employment relationship by notice or agreement and, if necessary, proceed to such termination. After this period, according to the Supreme Court, the difference in treatment (with the exception of rights arising from a collective agreement with a longer duration) can no longer be objectively and legitimately justified.

The manner in which the alignment of the employees' terms and conditions is achieved (within the limits set by law and contractual arrangements) is entirely up to the transferee employer. According to the Supreme Court, the legal regulation of the transfer does not exclude (does not prohibit) any deterioration of the working conditions of the transferred employees and even foresees that in connection with the transfer of rights and obligations under the employment relationship there will (may) be a significant deterioration of their working conditions.

How to deal with this in practice?

Employee transfers occur quite frequently in corporate practice, whether due to various forms of conversions, sales of plants, transfers of employer activities or other transactions. The practice so far has been to assume that the terms and conditions of employment of transferred employees must not be "touched" for at least some time after the transfer to the new employer. New internal regulations were already issued for all employees, but usually only after a certain period of time following the employee transfer.

However, the Supreme Court has now concluded that the principle of equal treatment of employees is paramount. And the terms and conditions of existing and transferred employees should be aligned almost immediately, strictly speaking, well in advance of the expiry of the two-month period following the transfer. Alignment is necessary even if it would mean a worsening of conditions – then the employee has the possibility to terminate the employment relationship within two months after the transition and claim a severance payment of one to three average monthly earnings according to his/her seniority (as in the case of organisational changes).

We leave aside the question of how the CJEU would view the possibility of a deterioration of conditions. More importantly for Czech transactional practice, any unequal treatment of employees post- transfer means a real risk for employers that lower-paid employees will successfully litigate for damages and additional remuneration up to the level of their better-paid colleagues doing the same work or work of equal value. For violation of the principle of equal treatment of all employees, the employer can also be fined up to one million crowns by the Labour Inspectorate.

Therefore, if an employer has remuneration conditions set unilaterally, i.e. by internal regulations or pay scales, it must issue new documents immediately after the transfer that set remuneration equally for all employees in accordance with the principle that employees are entitled to equal pay for equal work or work of equal value. According to the Supreme Court, it may even reduce the remuneration of a certain group of employees, but then it must take into account the possibility of their leaving due to a transfer.

In the case of bilaterally agreed wages and any other components of remuneration or working conditions, the situation is even more complex for employers. Employment contracts or other individual agreements can only be changed with the employee's consent. In practice, therefore, the employer has no choice but to raise the wages of lower paid employees to a higher level. This may entail considerable costs.

The above should be taken into account at the planning stage of any transaction that may involve the transfer of employees. Companies must carefully analyse the employment rights of the transferring employees and compare them with those of the transferee's employees, and at the same time, in order to set up the optimal procedure for unifying the terms and conditions, clarify whether the claims are from unilateral documents that can be changed flexibly, from bilateral individual documents that require the employee's consent to change, or from a collective agreement that is the only acceptable reason for differential treatment of the transferred employees for the duration of its effectiveness.

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

On 29 August 2024, the Supreme Court of the Czech Republic issued a rather ground-breaking judgment concerning the transfer of rights and obligations under the labour law relations of employees. Contrary to common practice and the case law of the CJEU, the Court ruled that the employer must unify the wage conditions of all employees no later than two months after the transfer, even allowing for the deterioration of the conditions of the transferring employees. If you are planning any transaction in which employees may transfer to another employer, we draw your attention to the conclusions of this judgment, which may have a general overlap with all similar projects.

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Preliminary questions to the Court of Justice of the EU from the Czech Republic

In the last 2 years, more precisely since 1 January 2023, the Court of Justice of the EU (CJEU) has received a total of 24 requests for preliminary rulings originating in the Czech Republic. Eight of them concern tax and customs issues. Let's take a closer look at these 8 questions arising from domestic litigation and concerning the interpretation of European law.

Overview

The Supreme Administrative Court (SAC) asked six of the eight preliminary questions concerning taxes and customs duties to the CJEU, while the remaining two were asked by the Regional Court in Ostrava. Half of the questions concern customs issues, three are in the field of VAT and the last one concerns the energy tax on electricity. One of these questions has already been answered by the CJEU, while the remaining seven are still pending.

Customs duty

The first two questions concern the classification of the SELVO 4800 electric wheelchair in the Combined Nomenclature (CN), which determines the rate of duty. The question is whether this wheelchair can be classified under the CN heading for wheelchairs with a duty rate of 0% or whether it is an electric scooter with a duty rate of 10%. The wheelchairs in question allow disabled persons with mild disabilities to move more easily than conventional wheelchairs. The SAC first raised the preliminary issue in March 2023[1], when it considered imports between 2013 and 2016. Six months later, the Regional Court in Ostrava[2] also asked the question concerning imports in 2021.

1 C-129/23 BG Technik
2 C-567/23 BG Technik II

In the meantime, the European Commission has issued an implementing regulation[3] explicitly excluding from the zero duty wheelchairs that can travel at 15 km/h. It seems that the customs administration has brought the importers of the wheelchairs in question to their knees. The CJEU will therefore rule on their tariff classification for the third time[4].

The Regional Court in Ostrava also asked a preliminary question concerning the anti-dumping duty[5]. Steel tubes were first imported from China to India, where they were cold worked. The question is whether such a change meets the definition of 'substantial processing or working' in order to change the origin of the goods (in this case from Chinese to Indian). Indeed, goods of Indian origin are not subject to anti-dumping duties.

The last question concerning customs duty is the question of the SAC[6] as to whether an original customs debt shall be reinstated by mistake even if the customs office incorrectly classifies the goods. This is a procedural case where the importer first declared the imported electronic products under the CN with a duty rate of 8.7% and subsequently applied for a change of classification to the CN with a duty rate of 0%. The customs office granted the request and reimbursed the duty assessed, but on subsequent inspection concluded that the original classification was correct and reinstated the duty. The question remains, however, whether the customs authority's incorrect reasoning on the classification of the goods can be regarded as an "error".

Value added tax

Other preliminary questions relate to VAT, the first of which arose from a situation where different legal entities provided internet access in the Czech Republic, each to its own customers[7]. However, they cooperated with each other and were managed by one natural person. The tax administrator saw the actual existence of the company (an association of persons without legal personality) and charged VAT to the Czech entity, a VAT payer, as its designated partner, in accordance with the Czech legislation in force at the time[8], also on the income of the other members of the company who were not VAT payers. The question put to the SAC is whether this special national legislation is not contrary to the VAT Directive.

The CJEU will also answer another question from the SAC[9], i.e. whether the VAT Directive, in conjunction with the general principle of proportionality, precludes liability for unpaid VAT by the recipient of a supply where it has already been denied the right to deduct tax on the same transaction on the ground of involvement in tax fraud. The Czech tax administrator claims that each of these institutes has a different objective and are not alternative procedures. On the other hand, the taxpayer understandably refuses to allow the public budget to be enriched by a duplicated tax.

3 EU Commission Implementing Regulation 2021/1367
4 See case C-198/15 Invamed Group
5 C-86/24 CS STEEL
6 C-330/24 Zelinka Customs Agency
7 C-796/23 Czech Network
8 This regulation has already been repealed. Newly, each shareholder is responsible for fulfilling his/her tax obligations separately.
9 C-276/24 KORNEO (insolvency trustee of the bankrupt company FAU s.r.o.)

An equally interesting question raised by the SAC[10] is whether a taxpayer who carries out both supplies not qualifying for input tax deduction and supplies that do qualify for input tax deduction has a reduced entitlement to deduct the inputs required as minimum technical equipment. Although the question concerns a medical facility, it can be expected that the CJEU will shed more light on the attribution of transactions received to transactions made.

The CJEU will also be answering another question of the Supreme Administrative Court, namely whether the VAT Directive in conjunction with the general principle of proportionality prevents the recipient of a transaction from being liable for unpaid VAT in a case where he has already been denied the right to deduct tax on the same transaction due to his involvement in tax fraud. The Czech tax administrator argues that each of these institutes has a different objective and are not alternative procedures. On the other hand, the taxpayer, for obvious reasons, refuses to allow the public budget to be enriched by a duplicate tax.

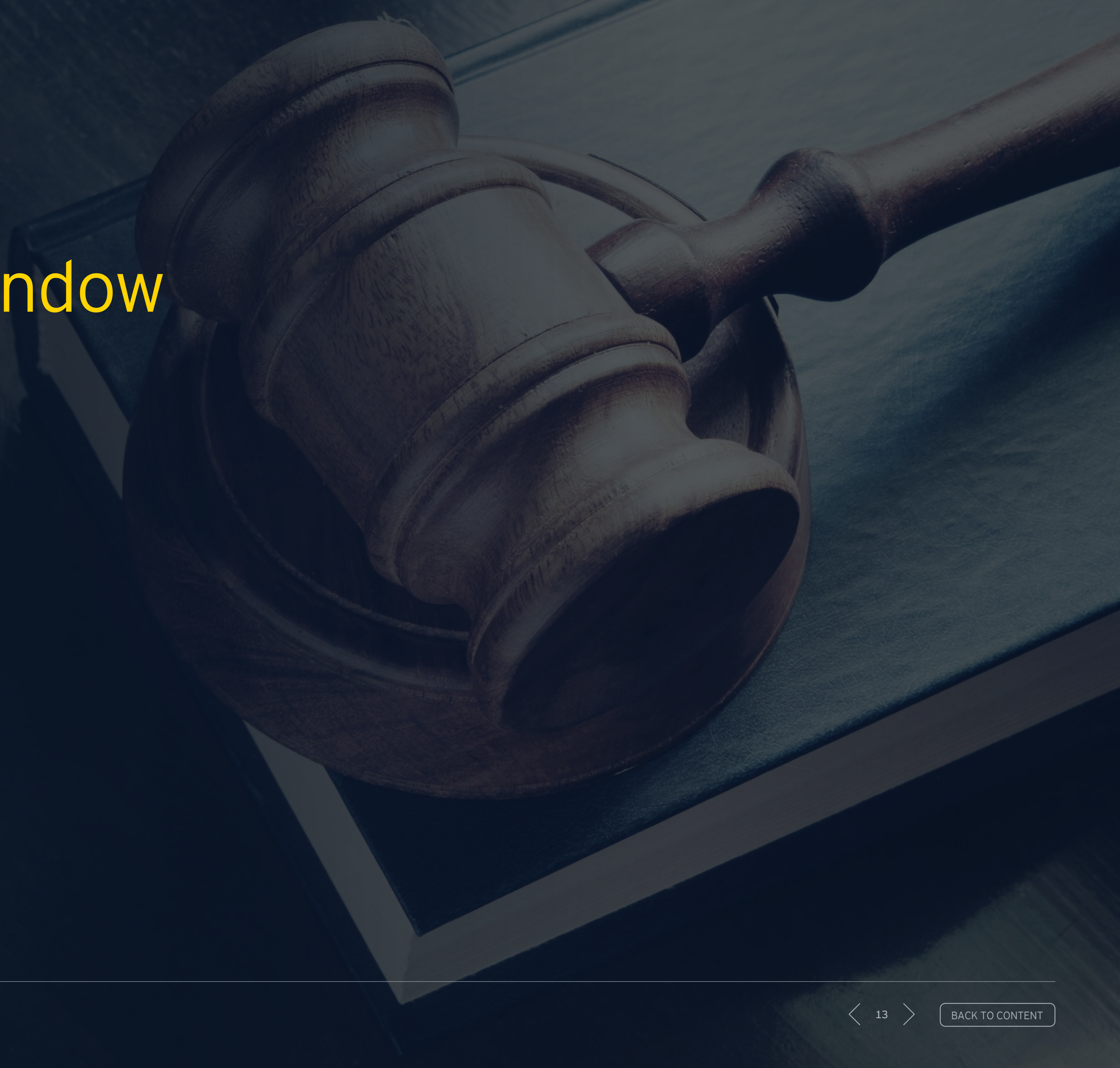
Energy tax

As early as March 2023, the SAC also asked the question[11] of whether electricity used to power machinery for processing (grinding and crushing) quarried limestone in a quarry and in nearby processing plants is considered "electricity used for mineralogical processes". The latter is exempted from the scope of the Directive on the taxation of energy products and electricity and is therefore not subject to energy tax.

This is the only one of the above questions that has already been answered by the CJEU. The conclusion is that the mineralogical process must consist of a substantial mechanical, physical or chemical transformation of the material, not merely a reduction in size.

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

10 C-513/24 Kolín Regional Hospital
11 C-133/23 Omya CZ



Judicial window

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Regional Court on the influence of an independent transaction by a parent company

The Regional Court in Hradec Králové (KS), in a recently issued judgment, commented on the tax administrator's assessment of tax on account of loss-making production under the order of a foreign parent company. At the heart of the dispute was the question of the functional and risk profile of the Czech company, namely whether the company was entitled to incur a loss on its production activities in accordance with § 23(7) of the Income Tax Act (ITA).

Background

- The Czech company (the "Company") was a member of a multinational Japanese group in 2016/2017 and its main activity was the production of parts and components for the automotive industry.
- The Company supplied its products to related parties and external customers.
- The Company reported a loss from its manufacturing operations for 2016/2017.
- The tax administrator assessed corporate income tax on the Company for the period 2016/2017 because, in its opinion, the Japanese parent company was responsible for the loss and should have compensated the Czech company for it.

View of the tax administrator

- The tax administrator assessed the Czech company to be a manufacturer with limited functions and risks, which should make a stable routine profit, not a loss.

- According to the tax administrator, the essential functions of strategic management, planning, customer negotiations and pricing were performed or directly managed by the parent company through the Company's top management.

- The tax administrator stated that the relationship between the Company and its parent company could be described as a controlled transaction of complex production carried out by the Company in accordance with § 23(7) of the ITA. The tax administrator identified a so-called fictitious (hypothetical) transaction between the Company and its parent.

- In this regard, the tax administrator pointed out that, though the Company sold its products to related parties and independent parties, all of its production was based on contracts and orders received as a result of negotiations and the parent's decision-making powers.

- The tax administrator emphasised that, given the functional and risk profile of the Company (a manufacturer with limited functions and risks), the difference between the profitability achieved and the market-normal profitability of comparable unrelated companies should have been compensated by the parent company in the tax period in question.

View of the Company

- The Company argued that the tax administrator incorrectly classified it as a producer with limited functions and risks. It argued that it was a 'licensed producer' (i.e. a producer responsible for key functions and bearing key risks, including market and capacity risks).

- The Company further argued that the tax administrator failed to prove the existence of a fictitious transaction with its parent company on the basis of which it assessed tax.

- According to the Company, the tax administrator did not document and prove that the parent company controlled and effectively managed the Company through persons appointed by it, nor how it caused the loss for which it should pay compensation.

What does the Regional Court (RC) have to say?

- The RC upheld the conclusions of the tax administrator and dismissed the Company's claim.

- The RC held that the tax administrator was justified in identifying a hypothetical transaction based on an analysis of the relationship between the Company and its parent company. The RC sided with the tax administrator's conclusions that the parent company performed all the strategic functions of negotiating with external customers and securing orders for the Company.

- The RC also based the existence of the fictitious (hypothetical) transaction on the personal interconnectedness of the Company's top management (e.g. the president and vice-president), which consisted of Japanese employees seconded by the parent company. There was no longer any position above these employees from which they could be managed by the Czech company.

- The RC upheld the tax administrator's conclusion that the Company is a manufacturer with limited functions and risks, while not accepting the Company's argumentation about its broader functional and risk profile.

- According to the RC, the Company has not demonstrated that it has control over risks within the meaning of the OECD Transfer Pricing Guidelines, where "control over risks should be understood as the ability and authority to decide whether to accept a given risk and to decide whether and how to respond to the risk, for example by the timing of investments, the nature of development programs, the design of marketing strategies or the setting of production levels."

What's the takeaway?

Although there were other nice titbits addressed in this case, such as the determination of the reference price, the choice of the transfer pricing method, or the appropriateness of the use of statistical methods (interquartile range), they were not that interesting from our point of view, as they have already been discussed many times. For us, the central fact was the argument about the employees seconded by the parent company through whom the Company was (also) to be managed.

Based on our experience, many domestic companies use a similar management structure, with key positions held by employees seconded by the parent company. However, even in light of this decision, this practice may be interpreted by the tax authorities as evidence of control of the subsidiary. We would therefore recommend that Czech subsidiaries of multinational groups pay close attention to this area.

This decision is the latest in a series of court decisions dealing with a parent company order and related potential compensation. It continues an existing trend where tax authorities are increasingly addressing this issue – sometimes in less and sometimes in greater depth and detail.

After recent positive rulings, things have not turned out well for the taxpayer in this case, at least for now. It remains to be seen whether and how the Supreme Administrative Court will eventually deal with the above.

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

The Regional Court found that although the Czech company also sold its products to independent parties, all of its production was based on contracts and orders received as a result of negotiations and the decision-making powers of the Japanese parent company. Thus, according to the court, the company performed a fictitious or hypothetical production service for its parent company, resulting in a loss-making production, which was to be compensated.

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Positive ruling on debt for equity based on a bank's request

In this issue, we bring you an interesting judgment addressing question of abuse of law in a situation where debt replaces capital of a company.

What happened and what was the view of the tax administrator?

- The year 2017 was involved.
- Company A was owned by Company B, with Company B's majority shareholder being Individual C (who was also the managing director of Company A).
- Company B decided to reduce the capital of Company A (primarily under other capital funds) by approximately CZK 90 million.
- Subsequently, Company A issued "crown bonds" totalling CZK 130 million (maturity 10 years and yield 12% p.a.), which were subscribed by Individual C.
- According to our understanding, the capital of Company A in the amount of approximately CZK 90 million was effectively replaced by the debt from the crown bonds.
- At some point in time, a loan of EUR 4 million was granted to Company A by Bank Z.
- The tax administrator did not like this, and levied withholding tax on the interest on the crown bonds, arguing that it was an abuse of law, which, in its view, should have been caused by the purposeful issue of crown bonds. The tax administrator considered the issue to be disadvantageous, uneconomic, lacking economic sense and purpose and resulting in a high interest cost burden on the Company and a gain of untaxed bond interest income. According to the tax administrator, the Company did not receive any funds by issuing the bonds, they only flowed through its bank accounts without affecting the amount of its available funds in any way.

What was the Company's view?

- The Company disagreed with the tax administrator's assessment. In its view, the transactions had a rational economic basis and could not constitute an abuse of law. The Company argued, inter alia, that

  - the banks, in order to reduce the risk of the long-term loan, required an increase in collateral, which led the Company to change the structure of its liabilities – this change, based on the Bank's recommendation, consisted in reducing the share of unpaid profits of previous years in the total financing and in issuing bonds, the repayment of which was to be subordinated to the bank loans, while the interest on the bonds was then to be reinvested back into the Group;

  - as a result of the issuance, the Company was considered a creditworthy borrower in the eyes of the banks and was granted long-term loans, and the Bank analysed the proceeds from the bond issue as a component of equity, with the result that the interest reinvested did not have an impact on the Company's cash flow;

  - the Company's long-term obligation to pay out capital would generate interest costs during the period of its non-payment, which would reduce the Company's tax base even without the bond issue – the bond issue itself would thus only represent a change of form or transformation of an existing obligation from a simple obligation towards the parent company into an obligation from the subscribed bonds. Thus, it was not the bond issue that gave rise to the "principal" of the debt, and it is therefore completely irrelevant whether this interest is paid from the original obligation or from the loan, credit or bonds into which the obligation was transformed.

View of the Regional Court

- The Court sided with the Company, basing its conclusion in particular on the following:

  - The Court referred to the affidavit of a corporate customer adviser at Bank Z, which showed that he had held discussions with Individual C about the possibility of providing long-term financing and that these discussions had led to the joint conclusion that it was necessary to restructure the liabilities – to reduce equity and raise foreign funds in the form of subordinated bonds. This restructuring was acceptable to the Bank on the basis that it met the parameters of a suitable instrument for long-term hedging.

  - In cooperation with Bank Z, the Company issued subordinated and non-transferable crown bonds, whereby it was agreed that the issued bonds would be subordinated to bank loans and the interest paid on the bonds would be used for reinvestment in the Group of companies so that the Company's cash flow would be stable.

  - Bank Z was the administrator and manager of the issue, and the bonds were treated as a component of equity capital for the purposes of the banking analysis and influenced the equity capital ratio. The change in the structure of the Company's liabilities was a sufficient precondition and guarantee for the Bank to continue to provide bank financing on a long-term basis. The Company thus fulfilled the conditions for a long-term loan of up to EUR 4 million.

  - The loan agreement in question implies an obligation on the part of the Company to maintain a minimum equity ratio of 25%, which includes, inter alia, the bonds issued *"for which payment of the nominal value is only possible after all obligations to the Bank have been repaid"*.

- On that basis, the Regional Court concluded that the Company had obtained a bank loan of EUR 4 million through the issue of the crown bonds, from which it had demonstrably financed its other business activities.
- According to the Court, the tax administrator does not discuss this bank loan in any detail, while not disputing that the Company obtained these funds. It merely states that it was part of the artificially created conditions of the issue, without in any way reflecting the fact that the Company actually obtained available funds in this way through the bond issue, i.e. that the issue itself was a means of obtaining available funds.
- Thus, in the circumstances, the Court held that the tax administrator failed to prove that the core reason for the chosen strategy, i.e. the issuance of the bonds to obtain the bank loan, was to gain a tax advantage.

What's the takeaway?

It seems that Czech courts give a lot of weight to the view of banking institutions when assessing transactions such as debt push-down or equity to debt swap. Attention should be paid to the detailed context of any given request and the related documentation. We would be happy to assist you in this regard.

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

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Claiming retrospective royalty exemptions to the EU Court of Justice

We present an interesting update on the conditions for applying the exemption under the Directive on a common system of taxation of interest and royalties between associated companies of different Member States (the "EU I-R Directive" or "Directive").

What's it about?

- A Company requested a decision on granting exemption from income tax on royalties under § 38nb of the Income Tax Act (ITA) implementing the exemption under the EU I-R Directive for the tax periods of calendar years 2014, 2015, 2016, 2017 and 2018.

View of the tax administrator

- The tax administrator granted the taxpayer the right to this exemption for the 2017 and 2018 tax years, but rejected the claims for the other periods. In fact, the Company applied for the exemption during June 2019, which, according to the tax administrator, was after the two-year period for the years 2014, 2015 and 2016.

View of the Municipal Court

- The Company defended itself against the tax administrator's decision by filing a lawsuit, which was dismissed by the Municipal Court in Prague. According to the Municipal Court, the tax administrator had correctly applied the two-year time limit when assessing the applications.

- The EU I-R Directive has been transposed into the ITA through § 38nb of the ITA. Although the ITA does not itself provide for a time-limit for submitting an application for a decision on the granting of an exemption from income, the Municipal Court held that this time-limit is nevertheless derived from Article 1(15), fourth sentence, of the Directive[12]. According to this provision, the time-limit for filing an application shall be at least two years from the date of payment of royalties. This provision of the Directive does not set a specific time-limit for the application, but sets a minimum standard.

- Since no time-limit has been laid down in national law in this respect, the Municipal Court held that, in accordance with the case-law of the Court of Justice of the European Union (CJEU), the direct effect of the Directive applies – the time-limit for submitting an application for a decision granting an exemption is therefore two years.

- According to the City Court, the Supreme Administrative Court (SAC)[13] also previously held that Article 1(15) is to be interpreted as meaning that the moment the requirements for exemption are met, the two-year period within which a decision may be requested under § 38nb of the ITA begins to run. Similarly, the exemption may be requested retroactively only in relation to the two-year period so defined.

View of the Company

- The Company filed a cassation complaint with the Supreme Administrative Court against the judgment of the Municipal Court.

- It disagrees with the application of the vertical direct effect of Article 1(15) of the Directive as it is applied in its case in a descending manner contrary to the case-law of the CJEU and to its disadvantage.

- According to the Company, the Municipal Court and the tax administrator do not distinguish between the terms of the Directive and the ITA and confuse them. Neither the ITA nor the Directive provide for a time-limit for proving the facts required by the EU I-R Directive, nor for submitting a request for a decision on the granting of an exemption under § 38nb of the ITA. The time-limit contained in Article 1(15) of the EU I-R Directive sets a minimum time-limit for the refund of tax already withheld, not for submitting a request for a decision.

- The application for a refund under Article 1(15) of the EU I-R Directive is a tax return under national law. According to the Company, this is also reflected in the wording of Article 1(15), which counts the minimum period from the payment of royalties, not from the actual fulfilment of the requirements for exemption. This provision cannot therefore be applied in a situation where the tax has not yet been withheld, since the tax cannot yet be refunded.

- According to the Company, national law provides for its own time-limits for the reimbursement of withheld tax, namely the time-limit for the assessment of the tax and the time-limit for the payment of the tax. There is therefore no reason for the direct effect of the EU I-R Directive.

12 Art. 1 para. 15: If the paying company or permanent establishment has withheld tax at source to be exempted under this Article, a claim may be made for repayment of that tax at source. The Member State may require the information specified in paragraph 13. The application for repayment must be submitted within the period laid down. That period shall last for at least two years from the date when the interest or royalties are paid.

13 See Judgment 3 Afs 250/2016-40 dated 4 January 2018.

View of the SAC

- The SAC has doubts about the interpretation of the EU I-R Directive and has therefore decided to refer the question to the CJEU for a preliminary ruling.
- The first question is whether the EU I-R Directive can be interpreted as allowing the source State, by virtue of a decision under Article 1(12), to grant an exemption also for a period prior to the time of the submission of such certificates and supporting information as the source State may reasonably require or the time of the decision itself[14].
- The first question therefore focuses on the possibility of *de facto* retroactive convalidation of the previous non-collection of tax in the event that the taxpayer proves *ex post* that the conditions for exemption were met. According to the Supreme Administrative Court, a mere textualist interpretation of the Czech language version of the EU I-R Directive does not show that the EU legislator envisaged or allowed the introduction of such a practice in the Member States. However, according to the SAC, it cannot be concluded that its existence is prohibited.
- However, the SAC has doubts as to whether such an interpretation is permissible. The legislative construction of the EU I-R Directive, according to the SAC, suggests that the decision under Article 1(12) is rather intended only to provide a formal declaration of the fulfilment of the criteria for granting the exemption with *pro futuro* effects.
- The SAC also does not consider it clear whether the decision to grant an exemption under Article 1(12) of the EU I-R Directive should be treated as a substantive or formal condition for granting an exemption. If the issue of a decision granting the exemption were a material condition, the possibility of granting the exemption for a period when the taxpayer did not yet have such a decision would be conceptually excluded. Clarification of the nature of the decision granting the exemption may thus be a prerequisite for answering the first preliminary question.
- However, if the CJEU answers the first preliminary question in the affirmative, the SAC asks a second, follow-up question. The question is whether the EU I-R Directive implies, either directly or indirectly, any time-limit for submission of an application for a decision granting an exemption under Article 1(12) of the EU I-R Directive or any time limitation as to the period preceding the submission of an application for a decision granting an exemption for which an exemption may be granted.
- The SAC doubts whether Article 1(15) of the EU I-R Directive implies the existence of any time-limit relevant for the submission of an application for a decision granting an exemption. According to the SAC, Article 1(15) of the EU I-R Directive establishes a minimum standard, i.e. a rule to which the Member States are subject when transposing the Directive and which cannot be interpreted as defining a time limit for the submission of an application for a decision granting an exemption by applying a descending vertical effect.

14 Art. 1 para. 12: The source State may make it a condition for exemption under this Directive that it has issued a decision currently granting the exemption following an attestation certifying the fulfilment of the requirements laid down in this Article and in Article 3. A decision on exemption shall be given within three months at most after the attestation and such supporting information as the source State may reasonably ask for have been provided, and shall be valid for a period of at least one year after it has been issued.

- The SAC has doubts that any time-limit is derived directly from the provisions of the EU I-R Directive, which would limit both the period within which a decision on the granting of an exemption may be requested and the period in relation to which an exemption may be granted.
- In the present resolution, the SAC does not comment on its own previous case law on this subject (see above).

What's the takeaway?

The possibility of retrospectively requesting the tax administrator to issue a decision on granting an exemption from income tax on royalties was previously generally admitted by the Supreme Administrative Court (3 Afs 250/2016 – 40). The newly submitted preliminary question may be understood as a clarification of the period for which retroactive application may be made or, depending on the view of the CJEU, unfortunately also as an end of this possibility.

So there is a potential for good news and also a bad news for taxpayers in relation to applying the EU I-R Directive exemption. We look forward to the resolution of this matter, and in the meantime we would be happy to discuss with you practical recommendations for your particular situation.

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

The answer to the preliminary questions of the Supreme Administrative Court by the Court of Justice of the EU may have a significant impact on the practical application of the retroactive application of the exemption under the Directive on a common system of taxation of interest and royalties between associated companies from different Member States.

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

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- The Tax Administration is launching the "friendly nudge"?
- The Supreme Administrative Court rejected a deduction for research and development support due to a failure to meet formal requirements?
- The new draft Accounting Act introduces major conceptual changes in the valuation of assets?
- The Anti-monopoly Office and the EC are focussing on agreements restricting competition in the labour market?
- EUDR legislation requires the creation of new TARIC codes that will be of interest to all companies seeking to obtain one of the legislative exemptions?