

Tax and Legal News

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AI – Authorial Inspiration (for the summer)

I decided to take an unconventional approach to the editorial for the summer edition of our EY Tax and Legal News. I'd first like to introduce you to the difficult intellectual process of creating such an editorial.

I don't know exactly how it is for my esteemed colleagues, the partners of EY's tax department, but for me the hardest part is always the beginning, i.e. finding a technical, but at the same time sufficiently engaging, topic that would appeal to a wide range of our readers and that I could treat lightly (not so technically). This year, my long-time colleague and friend Vlád'a Sopkuliak, for many years an excellent technical editor, editor-in-chief and good soul of our publication, helped me a lot with this process. Vlád'a knows me, so he treaded lightly: "You've got an editorial coming out in the summer issue. I know you've got a lot on your plate, so feel free to keep it short, like an optimistic greeting for the summer, or a list of legislative changes coming our way in the fall."

Thanks, Vlád'a, that shouldn't be difficult. But what legislative changes should I mention so as not to scare readers and spoil their summer? For example, the Corporate Sustainability Due Diligence Directive, which was approved this spring and which brings new extensive reporting obligations, will probably scare readers. Similarly, new European legislation bringing a whole raft of obligations in relation to deforestation regulation is likely to do the same. A little optimism could perhaps be created by talking about the amendment to the Czech law on conversions, which introduces divisions by separation as a new category of corporate conversion. But again, this is too technical a topic for the summer and my colleagues and

I have already written several technical alerts on it. Finally, I was most interested in the topic of artificial intelligence, i.e. AI, the regulation of which EU lawmakers are directing a substantial part of their attention to under the so-called AI Act, or the EU Act on Artificial Intelligence, which should be the world's first regulation regulating AI.

I myself see EY as a huge opportunity to accelerate technological progress and make routine activities easier for people. Within EY, we have developed our own Chat GPT-based software (isolated from the internet world to safeguard data confidentiality) and are currently experimenting around the world on how to use AI to improve our client services. But with the summer holiday season upon us, I've slipped back into playing with AI, which I've also been enjoying lately. I certainly don't mean to say that writing an editorial like this is a routine activity for me, not at all, but I was curious how AI would handle it.

So I gave our special EY AI chatbot the following task:

"Would you please try to design the text of the editorial for EY's publication of tax law articles to capture the upcoming holiday season and be a little lighter and more humorous?"

Within 3 seconds, the chatbot suggested the following:

Dear Friends and Business Associates,

Summer temperatures may make our heads swelter, but at EY we keep our cool to bring you the best of our professional world. In the summer edition of Tax & Legal News, we're serving up fresh information that's as refreshing as a glass of iced lemonade on the beach.

While you're enjoying a well-deserved holiday and sinking your feet into the warm sand, we bring you an overview of the most important developments in the tax and legal world. And don't worry, even though everything seems lighter in the summer, there are no cold showers waiting for you in the autumn. With us, you're safe and ready for whatever may come.

So, lots of sunshine, minimal paperwork and let every sunset remind you that even the most complex tax and legal mysteries have a solution. And if not, there's always a beach umbrella full of expert advice.

With a smile and sunglasses,

[Your name] Consultant, EY

So what do you think? I find it quite good from a "robot", even somehow human. It's a bit scary... . In terms of AI's human response, I've previously heard, for example, that as part of a commission to carry out market research and get the best bids from contractors, AI was able to claim to be a business employing disabled staff in order to get better bids from its human contractors. So if AI is capable of playing on human emotions and will continually improve in this ability (which is the principle of AI), then I guess some sensible regulation would really be needed so that we don't end up approaching the terrifying prognosis of Skynet from The Terminator, which for a long time was the only scary idea for my generation about how AI works.

But what does AI itself think about self-regulation? I tried again and asked our EY chatbot the following question:

Hi, what do you think about the upcoming AI Act within the European legislation and AI regulation in general? How real is the risk of AI getting out of human control and causing a catastrophe similar to how Skynet is portrayed in Terminator 2?

Again, approximately 4 seconds later, the chatbot came back with the following response:

Hello! The discussion about the upcoming AI Act in the framework of European legislation is very important because it tries to set rules for the ethical and safe development and use of artificial intelligence. The aim is to protect citizens from the potential risks that AI systems can bring, while promoting innovation and competitiveness in the field of AI.

The regulation of AI is a complex topic as it must balance the protection of the public, privacy, fundamental rights, while allowing for progress and development in this rapidly evolving field. Some experts and organisations welcome regulation as a way to ensure transparency, accountability and trust in AI systems, while others worry that overly strict regulation could hamper innovation.

As for the risk of AI spinning out of control and causing a disaster similar to Skynet in "Terminator 2," most AI experts consider this scenario highly unlikely, at least for the foreseeable future. Most current AI systems are "narrow AI", meaning that they are designed to perform very specific tasks and have no consciousness or motivation of their own. The risk of uncontrolled AI is more likely to be associated with potential programming errors, misuse of AI for malicious purposes or unintended negative impacts on society.

Nevertheless, it is important that safety protocols and ethical guidelines are established to prevent possible negative scenarios. AI safety research focuses on how to ensure that AI systems are reliable, safe, and that their actions are consistent with human values and interests.

Does this summary, with its emphasis on the absence of risk “at least for the foreseeable future”, reassure you? Let’s collectively believe that AI regulation will be successful, programming errors will not occur, and risk will be eliminated in the distant future. Meanwhile, I wish you a peaceful summer and plenty of rest from work worries.

AI, i.e. artificial intelligence, is already used by almost everyone and can be found in almost every field of human activity. But can AI help with a task as complex as writing an engaging editorial for EY Tax and Legal News?

Pillar 2

The background features a dark blue grid with several colorful, semi-transparent lines and shapes. A prominent orange line starts from the bottom left and extends towards the top right. A purple line starts from the middle left and extends towards the bottom right. There are also some teal and blue shapes scattered across the grid.



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Pillar 2 in the context of mergers and acquisitions

This time we would like to focus on selected impacts of Pillar 2 on the M&A process – specifically from the perspective of a minority investor.

Before Pillar 2

Consider Company A (from jurisdiction A), which has a wholly owned subsidiary B (from jurisdiction B). Company B does not qualify for any special tax treatment and has an effective corporate tax rate of around 15% (Company B is not a member of the tax group).

Next, suppose that Company A has agreed with an outside investor (I) that I will buy from it a minority stake in company B.

I has done his due diligence on Company B and has a reasonable idea of what he is buying – including the tax burden.

After Pillar 2

The situation is the same, except that we are already in a world where the Pillar 2 rules apply, and Companies A and B are constituent entities of a MNE group (let's call it Group X) to which the Pillar 2 rules apply.

In this situation, the investor should not be satisfied with just the figures for the Company B he is entering, but should ideally think about the potential tax implications of Pillar 2 for his investment.

This means not only checking whether the effective taxation separately for Company B is at least 15%, but also (among other things) whether Company B is not liable to tax because it is a constituent entity of Group X.

For example, suppose that Group X includes Company C, which qualifies for a special tax regime – let's call it "super-depreciation" – that allows it to take tax depreciation on assets in excess of their cost, resulting in low effective taxation.

Thus, although Company B would not itself be a low-taxed entity, it could, in certain circumstances, be subject to a top-up tax burden due to the existence of another low-taxed constituent entity of the same group (for example, in the form of a domestic top-up tax, if this would be allocated according to the amount of the profit of each entity or because of the related guarantee liability within the jurisdiction, or in the form of the application of the UTPR rule).

What's the takeaway

This and many other potential Pillar 2 implications should be reviewed prior to any transaction/acquisition and ideally reflected in contractual documentation. We will be happy to help you with this.

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

Potential Pillar 2 implications should be reviewed prior to any transaction/acquisition and ideally reflected in contractual documentation.

Law





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EU prepares a directive on shares with multiple voting rights

EU regulation of financial markets (in particular MiFID II and MiFIR) already allows the creation of regulated markets exclusively for small and medium-sized enterprises (SMEs). This category of enterprises typically includes start-up companies

Special regulated markets or multilateral trading facilities designed primarily for SMEs (in our case, for example, the Start market) give these companies the opportunity to finance the start-up of their activities on an equity basis, i.e. by selling their own shares and thereby increasing their own capital. However, the majority of SMEs currently still operate outside the regulated markets. Thus, they typically seek financing for their activities within the banking sector, i.e. through loans.

In March this year, amendments to both MiFID II and MiFIR were published in the EU Bulletin, clarifying (among other things) the requirements for transparency and efficiency of capital markets in the EU and increasing investor protection. Further changes to the regulation of financial markets were initiated by the publication of the Commission's proposal in December 2022 (the *Listing Act Package*), the key objective of which is primarily to support SMEs in entering the market and to reduce the administrative burden for already listed companies. This legislative package also includes a proposal for a Directive on structures comprising shares with multiple voting rights in companies applying to have their shares admitted to trading on the SME growth market (COM/2022/761 final) ("the Directive").

The objective of this Directive is to encourage company founders (primarily SMEs) to issue shares with multiple voting rights. This is because such an issue of shares with higher voting power, and therefore more influence on the management of the company, can ensure that the founders of the company have continued, sufficient control over the company. At the same time, the issue of another type of shares with lower or standard voting rights will bring the company the desired capital without giving financial investors the power to intervene significantly in the management of the company. However, these minority shareholders (investors) are to be protected by special safeguards under the Directive.

The EU considers it desirable to support the development of SMEs and their easier access to finance through regulated markets, as the EU considers SMEs to be the backbone of the European economy. Ultimately, support for SMEs should make European regulated markets more attractive and more competitive.

Many EU countries already allow (publicly traded) public companies to issue shares with multiple voting rights. These countries include, for example, Sweden, Finland, Denmark and the Netherlands. The Czech Republic also allows such an arrangement through the regulation of special types of shares in the Commercial Corporations Act and the related regulation in the Capital Market Undertakings Act.

On the contrary, several European legal systems are still based on the traditional share law principle of *one-share-one-vote*, which does not allow any deviation from the basic number of voting rights or amount of voting power corresponding to the amount of the contribution. These countries include, for example, Germany or Belgium (which impose this prohibition exclusively on publicly traded issuers) or Croatia and Austria (which prohibit shares with multiple voting rights entirely).

The EU therefore seeks to remove the inconsistent opportunities for SMEs to access finance through regulated markets and to promote (minimum) harmonisation in this area.

Current wording

In February this year, the Council and the European Parliament reached a preliminary agreement on the text of the Directive, which deviates in some aspects from the original text proposed by the Commission.¹

Materially, the Directive applies to shares with different (multiple) voting power. However, it does not apply to non-voting shares, shares with veto rights, nominee shares or so-called *loyalty shares*, i.e. shares with additional voting rights that are activated under certain conditions (typically by meeting a certain holding period).

In terms of the personal scope of the Directive, the Commission's original intention was to modify the rules exclusively for issuers falling into the SME category. This, in fact, is consistent with the background to the drafting of the Directive as explained above. However, the current version of the Directive extends its scope to all companies seeking to have their shares admitted for the first time to a regulated market or a multilateral trading facility allowing the admission of shares from SMEs (the so-called *SME growth market* under Article 33 of MiFID II). In fact, these systems may also partially trade shares of issuers not falling into the SME category. Thus, the reason for this modification was due to reservations about creating a dual regime for issuers (SMEs and others) entering the same SME market, which would be confusing for investors.

The Directive obliges Member States to allow a company that intends to list its shares on the market for SMEs for the first time to issue a specific type of shares with multiple voting rights on the basis of a decision of the general meeting adopted by a qualified majority vote, and to do so on the basis of a separate vote of all shareholder groups concerned (by type of shares). Member States must also ensure that the market organiser does not prevent the admission of such shares to trading. The Directive also requires Member States to allow companies already listed on designated markets to switch to a shareholding structure involving multiple votes.

Since the issuance of shares with multiple voting rights leads to the control of the company by a narrow circle of founders or shareholders and therefore increases the risk of their opportunistic actions for their own benefit (the so-called *private benefits of control*), the Directive stresses the necessity of adopting a minimum set of guarantees for other, "non-preferred" investors (i.e. shareholders with shares without multiple voting rights).

¹ This current wording is available [HERE](#).

One of the safeguards required by the Directive is the establishment of special voting rules for key decisions concerning the existence and functioning of the company (except for the appointment of elected bodies and operational matters), which will allow “non-preferred” shareholders to influence the management of the company.

As an alternative to the above, Member States may establish a maximum voting ratio between shares with multiple voting rights and ordinary shares without multiple voting rights. However, this rule still raises considerable controversy among Member States as it fundamentally interferes with the autonomy of the will within a company.

The Directive also offers Member States the possibility to introduce further safeguards to protect the interests of shareholders with “ordinary” shares. These safeguards include, for example, restrictions on the transfer or assignment of shares with multiple voting rights, time limitations on multiple voting rights or restrictions on multiple votes when the general meeting decides on measures to prevent adverse impacts of the company’s activities on human rights and the environment (i.e. measures relating to the company’s sustainable business).

Finally, the Directive increases the requirements for transparency of the shareholder structure and the distribution of influence in the company. It therefore requires the company to provide detailed information in the prospectus (in the context of an IPO) or in the annual financial report on the share structure, the types of shares and the rights attached to them, including any restrictions on their transferability. If there is a shareholders’ agreement known to the company which implies other restrictions on the transferability of shares, the company must also provide information about these contractual restrictions. Furthermore, if known to the company, the identity of shareholders holding shares with multiple voting rights representing more than 5% of the total voting rights in the company must also be disclosed.

It is unclear at this time what the final form of this regulation will be. It is still a source of considerable controversy. Particularly in countries that prohibit multiple voting shares, there is continuing opposition to this regulation on the grounds that it unduly interferes with the autonomy of corporate will.

We will keep you informed of further developments in this modification. 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 European Union is preparing to harmonise the treatment of shares with multiple voting rights to facilitate companies’ access to EU capital markets.

Judicial window

A close-up, high-angle photograph of a wooden gavel resting on a blue book cover. The gavel is positioned diagonally, with its head in the foreground and its handle extending towards the upper right. The wood of the gavel shows natural grain patterns and some wear. The book cover is a deep blue color with a subtle texture. The background is dark and out of focus, suggesting a courtroom or library setting.



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Loan vs. Equity – An American Perspective

We bring you an interesting American ruling from last year. The dispute between the American tax authority (IRS) and the taxpayer was about whether the given (currently uncollectible) intra-group loans are really loans or whether they should be viewed for tax purposes as equity (if they were a loan, then their write-off is tax-deductible - if equity, then not).

The American court interestingly goes through various criteria/indicators and concludes that for tax purposes, the given amounts are equity.

Below, we select from the interesting considerations of the court:

- ▶ A monetary transfer made between affiliated parties is subject to special scrutiny; however, having an affiliate relationship alone does not necessarily mean the transfer lacks economic substance.
- ▶ Also, an advance made by a creditor who is also a stockholder should be examined with closer scrutiny.
- ▶ Whether an advance of funds is, in substance, a bona fide business debt is a question of fact to be decided on the basis of all relevant facts and circumstances of each case. For a bona fide debt to exist, the parties to a transaction must have had an actual, good-faith intent to establish a debtor-creditor relationship at the time the funds were advanced.
- ▶ An intent to establish a debtor-creditor relationship exists if the debtor intends to repay the loan and the creditor intends to enforce repayment. The expectation of repayment must not depend solely on the success of the borrower's venture.
- ▶ Generally, unless the purported debtor provides a reasonable explanation for the lack of interest payments, the absence of interest payments indicates that the purported creditor is not expecting substantial interest income and, instead, is more interested in future earnings, a characteristic of equity.
- ▶ There are at least 13 factors which merit consideration in determining whether a claim should be recharacterized from debt to equity: (1) names given to the documents evidencing the indebtedness; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) status of the contribution in relation to regular corporate creditors; (7) intent of the parties; (8)

"thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) ability of the corporation to obtain loans from outside lending institutions; (12) extent to which the advance was used to acquire capital assets; and (13) failure of the debtor to repay on the due date or seek a postponement.

- ▶ In the context of related-party transactions, advances to closely held corporations constitute bona fide debts where they are made for a valid business purpose besides avoiding taxes.
- ▶ The Court considered each of the above-mentioned factors in the context of the situation at hand, with the following aspects tending to speak in favour of capital:
 - ▶ Because repayment of the loans at hand was dependent on future lot sales, this factor supports characterizing the advances as equity.
 - ▶ The economic reality of the situation was that the advance recipients had no ability to repay the debts. Therefore, although there was an enforceable right in form, there was not one in substance.
 - ▶ There was no real expectation of repayment as evidenced by the complete lack of interest payments and inconsistent repayment of the principal.
 - ▶ The purported debtors were thinly capitalized when they received the advances.
 - ▶ The interests between the purported borrowers and lenders were "significantly intertwined."

- ▶ The credit line at hand was unsecured, had no guaranty, and required no payment for several years. It is very difficult to believe an unaffiliated lender would advance that much money on similar terms.
- ▶ After weighing all the above factors in the context of this case, the Court concluded that the advances did not constitute debt.

The above can also be an inspiration for the assessment of selected situations in the Czech environment.

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

An intent to establish a debtor-creditor relationship exists if the debtor intends to repay the loan and the creditor intends to enforce repayment. The expectation of repayment must not depend solely on the success of the borrower's venture.



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The Supreme Administrative Court on the issue of abuse in debt refinancing

We have here for you a decision of the Supreme Administrative Court (SAC) on the issue of abuse of law in taxes, which is worth your attention (3 Afs 40/2023 – 44).

What it was about in simple terms?

- ▶ A company financed the construction of a power plant by, among other things, a loan from the majority shareholder.
- ▶ At the end of 2012, the company issued crown bonds (with a fixed interest rate of 5% per annum and a maturity of 20 years).
- ▶ These bonds were subscribed by the controlling shareholder and his obligation under the subscription was set off against his loan claim against the company.
- ▶ No tax was withheld on the interest paid on these bonds under the rules in effect at the time.
- ▶ The tax administrator (and subsequently the Regional Court) found that the transaction was without real economic significance, the purpose of which was to create conditions for obtaining a tax advantage. It assessed this conduct as an abuse of law and imposed

withholding tax on the interest paid (the question of the deductibility of the interest was not at issue in these proceedings).

What does the SAC say?

The SAC sided with the tax administrator, and we highlighted some of the interesting aspects:

- ▶ According to the SAC, the issuance lacked its own economic purpose (other than to obtain an unjustified tax advantage), which is to obtain funds from foreign sources. The company did not obtain new funds, it merely replaced one legal title of the claim with another title that was tax advantageous for the shareholders.
- ▶ Although the interest rate on the bonds was set at the same rate as the original loan (5% per annum), given the longer maturity of the bonds, the company's total interest expense will be higher than it would have been had the company continued to pay interest under

the loan agreements. From this point of view, according to the SAC, the transactions lack economic advantage for the company and their purpose is obviously to obtain a tax advantage for its shareholder.

- ▶ As regards the economic rationality of the refinancing, the SAC notes that even if the bonds had not been issued and thus no change in the title of the majority shareholder's claim on the company, the company's potential "bargaining position" would have been the same in the event that it had to negotiate a different maturity or different terms for the repayment of its obligation. The creditor would still be a person connected to it. This reasoning therefore appears to the SAC to be expedient and does not support the company's claim that it was necessary and therefore economically justified to issue the bonds.
- ▶ The absence of an economically rational sense of the transaction is a circumstance indicative of the objective and subjective element of abuse of law. In assessing whether an abuse of law has occurred, the SAC holds that the objective and subjective criteria need not be explicitly distinguished / assessed strictly separately.

What's the takeaway?

- ▶ The optimist will say that the above arguments cannot be generalised and must be read in the context of the involvement of the crown bond element. At least two gloomy thoughts come to mind for the pessimist: (i) if the court so wishes, then - it seems - no one needs to bother too much with the technical argumentation regarding the fulfilment of both the subjective and objective elements of abuse of the law, and (ii) the considerations on the economic sense of refinancing outlined above may potentially problematise certain intra-group (re)financing situations even without the crown bond element.

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

If the court so wishes wants, then - it seems - no one needs to bother too much with technical arguments about the fulfilment of both the subjective and objective elements of abuse of rights. At the same time, the court's suggested considerations about the economic sense of refinancing can potentially problematise certain intra-group (re)financing situations even without the crown bond element.



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Question to the CJEU on exemption limits under the EU Directive on the common system of taxation of parent companies and subsidiaries

In this issue, we bring you an interesting reference for a preliminary ruling from Lithuania to the Court of Justice of the European Union (CJEU) concerning the application of the EU Directive on the common system of taxation of parent companies and subsidiaries (EU PS Directive).

What didn't the Lithuanian authorities like?

- ▶ A Lithuanian parent company received dividends from its UK subsidiary (when the UK was still in the EU).
- ▶ Although the formal conditions for exemption under the EU PS Directive have been met, the Lithuanian authorities question its application for the following reasons:
 - ▶ Due to the nature of the activities (organisation of the distribution of popular digital games), staffing appeared to be insufficient (one manager managing seven other companies).
 - ▶ From the point of view of the tax authorities, the UK subsidiary had no real economic activity - it had no proper office (many companies registered at that address), equipment, website or email.

- ▶ As part of its investigation, the tax administrator concluded that the necessary activities were in fact carried out by the parent company.

What was the taxpayer's perspective?

- ▶ The company disagreed with the view of the tax authorities - a selection of its arguments:
 - ▶ The business model was gradually changed - the role of the British subsidiary gradually diminished for objective reasons.

- ▶ The initial involvement of the UK company was necessary because in the early days of the activity it was not possible to conclude distribution agreements directly between the Lithuanian company and Apple/Google, so the role of the UK company as an intermediary was necessary.
- ▶ Due to the role of the company, there was no need for office space or a website.
- ▶ The reasons for the UK company's involvement need to be considered in the context of the overall historical development, i.e. not just from the perspective of when its activities were curtailed and dividends were received.
- ▶ The situation cannot be regarded as a tax avoidance structure as the mere fact that the UK subsidiary realised a profit which is subsequently exempt on distribution in the hands of the Lithuanian parent does not constitute a prohibited tax advantage, especially as the tax paid in the UK was higher than the tax on a similar profit realised in Lithuania.

The view of the CJEU is not yet known

The Lithuanian authorities are therefore asking the CJEU whether, in the circumstances described above, the refusal to exempt the dividends in question in the hands of the Lithuanian parent would be in line with the principles of EU law. The CJEU's view on this issue will be important, as these and similar considerations by tax administrators could potentially problematise many practical situations. So we will see.

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

The Lithuanian parent company received dividends from a UK subsidiary (while the UK was still in the EU). While the formal conditions for exemption under the EU PS Directive were met, the Lithuanian authorities question its application, citing, among other things, the subsidiary's inadequate staffing.

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Did you know that:

- ▶ The Ministry of Finance is working on an amendment of the Top-up Taxes Act (Pillar 2), with significant changes expected compared to the first working version?
- ▶ Following questions from the public, the Ministry of Finance has indicated its intention to extend until 2026 the tax deductibility of aid to Ukraine in the extent provided by Act No. 128/2022 Coll? [↗](#)
- ▶ The OECD has issued a further Administrative Guidance on Pillar 2? [↗](#)
- ▶ In a recent decision, the Court of Justice of the European Union addressed the time limit for the submission of information for the assessment of a VAT refund claim? [↗](#)
- ▶ A program to support combined heat and power has been approved? [↗](#)