LEGAL TAX AUDIT

NEWSLETTER
October 2024

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LEGAL - TAX – AUDIT - ACCOUNTING

YOUR SAFE HARBOUR

AMENDMENT TO THE INCOME TAX ACT

The Ministry of Finance of the Czech Republic has prepared an amendment to the Income Tax Act which responds to changes introduced by the new Accounting Act. Given the number of fundamental changes and the state of the legislative process, it is unlikely that the Act will become effective as early as 2025.

Tax depreciation - simpler and completely different

- Property whose value exceeds CZK 100,000 will be depreciated.
- Depreciation groups as we know them now are coming to an end. It is proposed to introduce three bands according to the depreciation period:
  - 180 months for goodwill,
  - 360 months for real property whose value exceeds CZK 2 million,
  - 60 months for other assets.
- Tax depreciation period will not be interrupted! Taxpayers reporting a loss have been using the possibility to interrupt tax depreciation to eliminate the amount of the loss. However, the Ministry of Finance considers this option to be an unsystematic element that allowed taxpayers to purposely change their tax base without reflecting the economic reality. It will be mandatory to apply tax depreciation for the entire period of holding the property.
- Tax depreciation will not be calculated on an annual basis but on a monthly basis.
- Only the straight-line depreciation method will be left. The monthly tax depreciation is calculated as the tax value of the asset divided by the number of months of depreciation (see the three bands mentioned above).

Application of IFRS profit or loss for determining the tax base

The tax base in the Czech Republic is currently determined in accordance with Czech accounting regulations. However, there are a number of entities that are required to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS).

For the purposes of calculating the income tax, these entities must convert the IFRS result to the result determined in accordance with Czech accounting regulations. This obligation entails significant administrative costs for both the taxpayers and the tax administration, for which (by its own admission) it is essentially impossible to verify such conversions.

It is proposed that it will be possible to use the IFRS result for determining the tax base. For the purposes of tax calculation, the Act should eliminate only such items that are not suitable for calculation of the tax base – so-called permanent differences that lead to permanently different results compared to the Czech accounting rules.

Technical appreciation

The term technical appreciation shall be replaced by the term additional appreciation. Additional appreciation increases the value of the asset and applies only to tangible goods or the right of use. It does not apply to intangible assets which are depreciated only on an accounting basis. An additional appreciation will be deemed to exist if the subsequent expenditure on the asset being appreciated exceeds the total for a given tax year:

- an absolute amount of CZK 100 thousand, or
- a relative amount of 10 % of the value of the property (but not more than CZK 10 million).

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The introduction of a relative limit will allow taxpayers to claim a higher amount as a lump sum in the case of more valuable assets. For example, in the case of property valued at CZK 5 million, the taxpayer will be able to use a higher limit (amounts above CZK 500,000 will qualify as additional appreciation). A lower amount will qualify as a one-off expense.

Subsequent expenditures above CZK 10 million will always be subject to additional appreciation. Taxpayers who voluntarily choose to treat amounts below the statutory limits as additional appreciation will be allowed to do so.

Unpaid contractual penalties and employee insurance payments

Under current legislation, the tax treatment of contractual penalties and employee insurance payments depends on when they are actually paid. The Act aims to simplify this and proposes that their tax treatment will be based on their reflection in the books without the need to examine whether or not they have been paid.

The draft amendment is very extensive and contains a number of fundamental changes. We will keep you informed about the status of the legislative process and any other new developments.

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RESEARCH AND DEVELOPMENT TAX RELIEFS

The state and the European Union do not only provide subsidies for business development. Other instruments include research and development (R&D) tax reliefs. Simply put, a company can deduct part of the money spent on research activities from its taxes. This possibility has existed in the Czech Republic for years, but it has been used minimally. The low interest is mainly due to the uncertainty of taxpayers as to whether they can meet all the legal conditions and the (relatively high) risk of assessment of additional tax during an audit by the tax office. Even so, this option should not be ignored.

Positives of R&D deductions

- This tax instrument allows companies carrying out R&D to reduce their corporate income tax each year (CZK 210,000 per every CZK 1 million of expenditure on R&D projects).
- In subsequent years, the R&D deduction can again be used to deduct between 100 and 110% of expenses incurred on implementation of R&D projects from the tax base.
- If the legislative conditions are met, any company is legally entitled to the tax deduction without government approval (unlike subsidies).
- In the event of a tax loss, the R&D deduction can be claimed in the following three tax years.
- To some extent, the R&D deductions can also be combined with subsidies.
- There is no lower or upper limit on R&D expenditure.
- The deduction can also be claimed under certain conditions for unfinished or unsuccessful R&D projects.
- In case of doubt, the taxpayer can request a binding assessment of the R&D expenditure included in the deduction.

R&D tax reliefs have their pitfalls

The new rules for claiming R&D deductions have been in force since 1 April 2019, yet some companies unknowingly follow the old rules. Under the current ones, they are no longer obliged to prepare project documentation before starting the research activities. They only have to notify their intention to deduct the costs of a specific R&D project to the relevant tax office.

Companies also often forget about the obligation to keep separate records of eligible costs, either in the accounting system or in separate calculations, spreadsheets, etc.

If the company prepares summary project documentations, the tax administrator may conclude that the company is implementing several separate projects supported by a single documentation. This could violate the statutory conditions as separate project documentation should be prepared for each individual project.

It often happens that the documentation activity in a company ends when the project documentation is approved and signed. However, especially for cost-significant projects with a development period of several years, it is necessary to keep a record of their progress, for example by means of annual evaluation reports or at the end in the form of a final report. Companies also sometimes refer to various documents in the project documentation but are unable to produce them during a tax audit.

RESEARCH AND DEVELOPMENT TAX RELIEFS

Audits and heavy administration burden

As R&D deductions represent a form of tax relief, a tax audit is more likely to occur. Such an audit mainly focuses on the following areas:

- meeting the formal requirements of the R&D project,
- definition of the objective of the R&D project,
- defining how the progress of the project will be monitored and evaluated,
- separate tracking of R&D costs,
- examining the moment of the start of the R&D project,
- examining the types of costs included in the deduction,
- demonstration of a measurable element of novelty and research uncertainty,
- deduction of external staff costs.

In addition to the increased interest of the tax authorities, the negatives may include, for example, increased administrative requirements or the keeping of separate cost records. Throughout the process, it is also essential to keep a continuous record and store all documentation related to the research project (from the initial meeting minutes to the various presentations or project change sheets, etc.).

As of 2024, a new law on top-up taxes came into force, which sets a minimum effective tax rate of 15% for certain taxpayers. The application of the R&D deduction to domestic entities that are members of large multinational or domestic groups subject to top-up taxes could be counterproductive because, although the tax base could be reduced, top-up taxes would be levied.

If you decide to claim a R&D deduction despite the above-mentioned pitfalls, please keep in mind that perfect adherence to formal requirements is an absolute must. If you have any questions about this area, please contact us.

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TAX DEDUCTIBILITY OF INTEREST ON A LOAN FOR THE PURCHASE OF A BUSINESS SHARE

Interest on a loan received in connection with the acquisition of a share in a company is listed as a non-deductible expense in the Income Tax Act. The reason is that the income generated from the parent company (from profit sharing or from the sale of a share) is either exempt from income tax or subject to withholding tax, so there is no taxable income generated in respect of the interest expense.

In the case of a merger of the parent company and the subsidiary after a loan-financed share acquisition, the tax deductibility of the interest is disputed. There are two different approaches to this issue among both the professional community and the tax administration:

a) The interest charged on the loan is tax deductible because the acquisition of the subsidiary with its subsequent merger into the parent company is just a form of acquisition of assets generating taxable income.

b) The interest charged on the loan is not tax deductible because the loan was for the acquisition of a company and the subsequent merger does not change this. The purpose of the merger is only to make the interest tax deductible, which may qualify as an abuse of law.

The legal regulation in the Income Tax Act is relatively concise and gives courts great leeway to decide. Below are two recent judgments of the Supreme Administrative Court (SAC) on this issue.

Merger as a condition of bank financing

On 25 June 2024, the Supreme Administrative Court issued a judgment in favour of the taxpayer in 8 Afs 246/2022-61, confirming the tax deductibility of interest in the following case. A foreign investor agreed to take over an international group of companies, which included a Czech manufacturing company. The acquisition was financed by an independent consortium of banks. The drawdown of the loan was divided into several separate transactions at different levels of the holding company, each transaction being anticipated by a facility agreement. In the Czech Republic, the takeover was carried out by setting up a new company in the Czech Republic, which took out a loan from the bank and used it to buy a Czech manufacturing company from a foreign group company. Subsequently, the Czech companies merged. The acquiring company claimed the interest as a tax-deductible expense from the date of the merger. During the tax audit, the tax office challenged the deductibility of the interest on the grounds that it qualified as an abuse of law.

An abuse of law can be described in simple terms as execution of transactions that lack economic purpose and the sole purpose of which is to obtain a tax advantage. In the context of the decisions of the administrative courts, an abuse of law has two elements, an objective one and a subjective one. The objective element consists in the fact that a tax advantage is obtained contrary to the intended purpose of the legislation. The subjective element consists in the artificial creation of conditions to achieve a tax advantage. Both elements must be present at the same time in order to conclude that an abuse of law has occurred.

In the present case, the SAC found the presence of the objective element of an abuse of law, but not the subjective element. The decisive argument for economic rationality was primarily the requirement of an independent bank that

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financed the entire project. According to the court, it was entirely rational for the bank to want to be assured of repayment of the debt and therefore to require the debt to be shifted to the level of the manufacturing company. Not only will the manufacturing company pay the debt from its revenues and assets, which gives the bank as a creditor a higher level of security for repayment, but even if it enters insolvency, the bank will have the possibility to be directly satisfied from the financed assets and thus have a stronger position as a secured creditor. According to the court, it was economically rational for the bank to condition the loan on a part of the loan being shifted into the manufacturing company by the merger.

A similar case with a different ending

On 26 July 2024, the Supreme Administrative Court issued Judgment No. 5 Afs 195/2022-51 on the issue of tax deductibility of interest, which, however, turned out negatively for the taxpayer.

The situation is similar in many respects to the previous case. Again, the investor entered an international group, the change of ownership took place abroad, the investment was financed by an unrelated bank, the Czech company was sold to a newly established company in the group as part of the post-acquisition steps, which took out a loan to cover the purchase price, and the economic rationality of the subsequent merger was defended by the bank's requirement. The main difference from the previous case was the following:

a) The bank granted a loan to a foreign company and the Czech company took out a loan from this group company.

b) The Czech company submitted a contract between the foreign company and the bank, which included a request for reorganization of the Czech company, but it concerned a change of legal form to a limited partnership. The taxpayer was unable to document the change in the bank's conditions of the loan which would require a merger.

In the opinion, the SAC stated that the transactions in question were *de facto* "self-purchases" the loan was not effectively used for the taxpayer's business, which fulfilled the objective element of an abuse of law. The SAC upheld the income tax assessment by the tax authority.

Conclusion

A comparison of the two cases shows that the form of the contractual documentation with the financing bank played a major role in the court's decision. An element that influenced the tax authority's assessment of the case in both cases was that the buyer of the Czech company was a group company. However, there are more relevant aspects. We will be happy to help you set up acquisition transactions.

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NON-CASH MEAL ALLOWANCE FOR FORMER EMPLOYEES FROM 1 JULY 2024

As of 1 January 2024, non-cash meal allowances provided to former employees who are retired or receive disability pension was subject to taxation and social security and health insurance payments. The reason was that such former employees did not meet one of the conditions for tax exemption, namely working at least three hours per shift.

Act No. 163/2024 Sb., published in the Collection of Laws on 19 June 2024, brought certain changes to the Income Tax Act. Among other things, it reintroduced tax exemption of meal allowances in the form of non-monetary benefits provided to former employees, up to the statutory limit (CZK 116.20 in aggregate per calendar day for 2024).

The new provision of Section 6(9)(t) of the Income Tax Act, which deals with the exemption of such contributions, came into effect on 1 July 2024, but according to the transitional provisions, the exemption applies retroactively from 1 January 2024. If the employer uses the option to exempt the allowance retroactively, it is necessary to make an adjustment to the withheld tax advances to ensure that this income will not subject to health and social security insurance payments.

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"VAL-MECH" AMENDMENT TO THE LABOUR CODE CAME INTO FORCE ON 1 AUGUST 2024

The "Val-mech" amendment to the Labour Code (i.e. not yet the so-called “flexible amendment”, which is the next in line) came into force literally overnight. On 31 July 2024, it was signed by the President and on the same day it was published in the Collection of Laws under No. 230/2024 Sb. Since, with the exception of the self-scheduling of working hours, the amendment was to come into force on the first day of the calendar month following its publication, this happened already on 1 August 2024.

Why is the amendment called "val-mech"? Primarily because it introduced a new way of setting the minimum wage through a “valorisation mechanism”. The valorisation mechanism is based on the forecast of the average gross monthly wage (set by the Ministry of Finance of the Czech Republic always by 31 August) and a coefficient for calculating the minimum wage (set by the government by a decree always for two years in advance). It sounds complicated, but there is no need to worry about complex calculations. The minimum monthly and hourly wage for the following calendar year will always be announced in the Collection of Laws by 30 September of each year.

What else has changed since 1 August 2024?

- Abolition of the institution of guaranteed wage in private sector, which was replaced by the institution of guaranteed wage in public sector .
- Possibility to agree remuneration under a DPP/DPČ taking into account possible night work, work in a difficult working environment or work on Saturdays and Sundays.
- Abolition of the employer's obligation to create a written holiday schedule.
- Modification of the provisions on secondary liability for subcontractors' employees' wages.
- Specific adjustments aimed at improving working conditions in the health sector.
- Changes to collective bargaining.

Provisions regulating self-scheduling of working time will not come into force until 1 January 2025.

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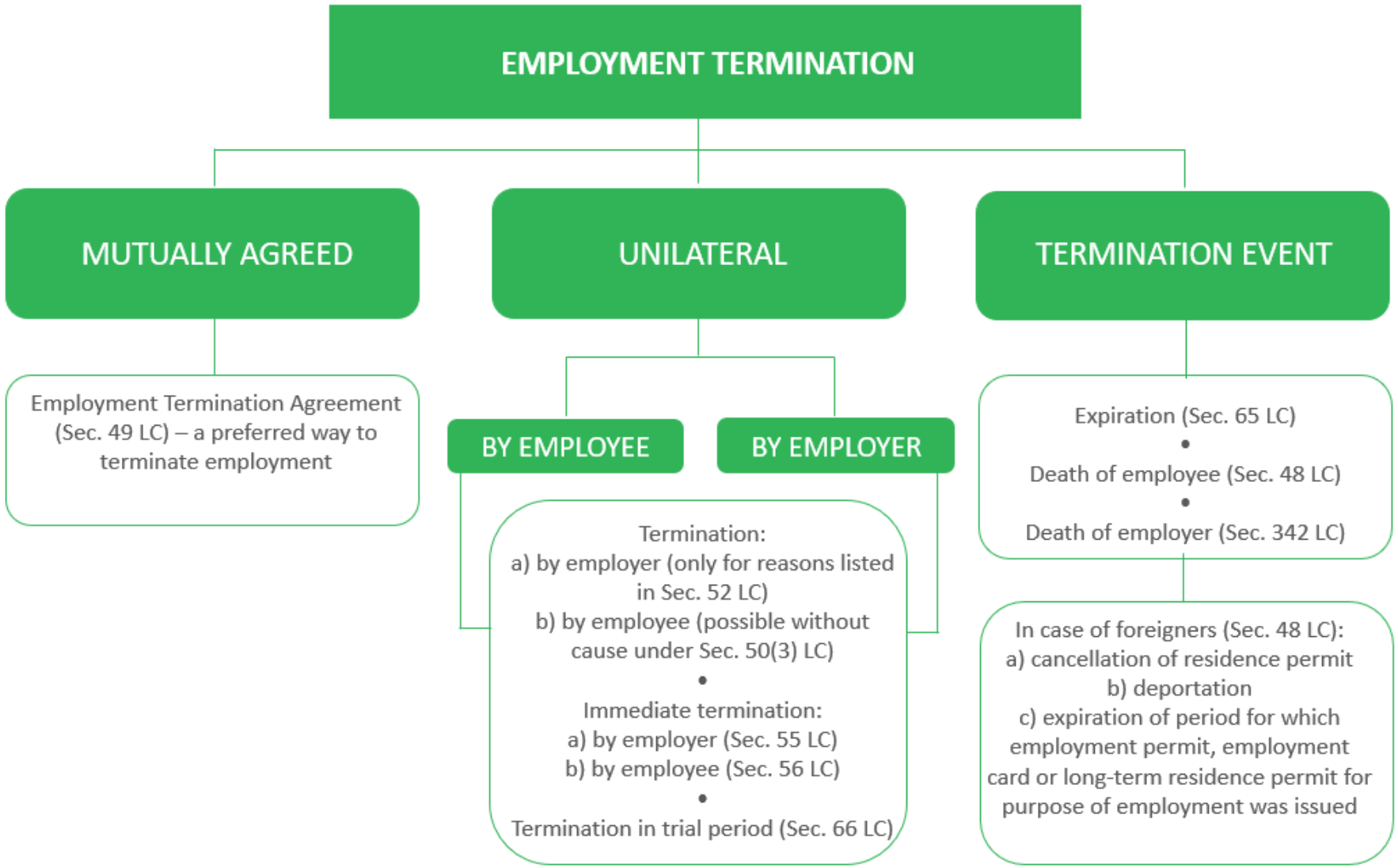
EMPLOYMENT TERMINATION – SCHEMATIC OVERVIEW

This overview will help you to understand termination options and the key differences between them.



CASE LAW: TERMINATION OF RESIDENTIAL LEASE WITHOUT INSTRUCTION FOR TENANT

In an important decision of the Supreme Court, Case No. 26 Cdo 2029/2023, dated 15 April 2024, the court dealt with the question of the validity of a notice of termination of a residential lease that did not meet the requirements for instructing the tenant about the right to file a lawsuit to review the validity of the notice within the statutory time limit.

The plaintiff, a tenant, sought a declaration that the notice of termination given by the landlord, the defendant, on the grounds of alleged gross breach of the tenant's obligations, was invalid. The essence of the breach was unauthorised sublease of the apartment to a third party without the landlord's consent. The notice contained the following instruction. "*You have the right to object to the notice and to request that the court review the validity of the notice*."

At first glance, it appears that the landlord has fulfilled the obligation to instruct as provided for in Section 2286(2) of Act No. 89/2012 Sb., Civil Code ("*If the landlord terminates the lease, he shall instruct the tenant of his right to object to the termination and to request a court review of the validity of the termination, otherwise the termination shall be null and void.*"). We do not find any obligation to inform the tenant about the time limit for filing for a judicial review of the termination in this provision (or in any further provisions of the law). Only Section 2290 of Act No. 89/2012 Sb., Civil Code, provides that "*The tenant has the right to file a petition with the court to review whether the termination is justified within 2 months from the date of receipt of the termination notice.*"

Nevertheless, the Court of Appeal concluded, beyond what is stated in the law, that due to the absence of instruction to the tenant about the time limit for filing a lawsuit to review the validity of the termination, the termination was null and void, i.e. should be deemed as had it not been given.

The Supreme Court, in agreement with the Court of Appeal, concluded that the failure to comply with the duty to give notice was a breach of the mandatory standard protecting the tenant, who would not learn in time of his right to defend himself in court. Therefore, such an incomplete notice of termination of the lease of the apartment does not produce any legal consequences and is therefore null and void, since such a breach is not only contrary to the law but also manifestly disturbs public order.

In view of the above, we recommend that landlords pay attention to the exact wording of notices used to terminate residential leases. You must instruct the tenant not only pursuant to Section 2286(2) of Act No. 89/2012 Sb., Civil Code, on the right to file a petition for review, but also pursuant to Section 2290 of Act No. 89/2012 Sb., Civil Code, on the two-month period within which the petition must be filed with the court.

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CASE LAW: DISCRIMINATORY NATURE OF JOB ADVERTISEMENTS

In its recent judgment (Case No. 9 Ads 174/2023), the Supreme Administrative Court again addressed the issue of discrimination against job applicants resulting from gendered wording of a job advertisement. The case concerned a job advertisement posted by the Czech Medical Chamber on its Facebook profile, which read: *Nabídka práce, Kancelář České lékařské komory se sídlem Lékařská 2, Praha 5, hledá administrativní* ***pracovnici*** *–* ***asistentku*** *revizní komise'*.

The Regional Labour Inspectorate believed that the Czech Medical Chamber had violated the prohibition of discrimination on the basis of sex and imposed a fine of CZK 15,000 for the offence. On the other hand, the Regional Court in Ostrava did not consider the advertisement to be discriminatory and annulled the decision on the fine. The feminine gender was used only in the job title of the advertisement, the rest of the text was phrased neutrally. According to the court, this was also permissible, since similar administrative work had been predominantly performed by women since the entry of women into the labour market.

However, the Supreme Administrative Court ultimately ruled in favour of the Labour Inspectorate because the title of the position offered made it clear that it was suitable only for women. The advertisement must be considered as a whole and cannot be divided into the title and the rest of the text. The overall message of the job offer was thus capable of negatively influencing the interest of potential male applicants in the advertised position. The Court therefore concluded that the advertised job offer was discriminatory and referred the case back to the Regional Court.

As can be seen from the above, employers must be careful not to discriminate on the basis of, among other things, sex when drafting job offers. Inappropriately gendered language may qualify as discriminatory, which may result in a fine of up to CZK 1,000,000 for the employer. In practice, Labour Inspectorates commonly review job advertisements, often after being tipped by a job applicant.

What phrases should employers avoid?

- We are looking for men for the position of welder
- We are recruiting a (female) payroll accountant
- We are looking for a manual worker – work more suitable for men because of the physical demands
- The position is suitable for women only
- Suitable for women on maternity leave

We will be happy to assist you in drafting suitable wording for your job offers that meet all anti-discrimination requirements.

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DID YOU KNOW THAT…

- If an employer fails to train its employees working remotely in OSH or fails to provide the insurance company with a certificate of such training, it may constitute an exclusion from the employer's liability insurance? Thus, in the event of an occupational injury or another insured event, the insurer may not cover the employee's compensation claims. The costs can amount to millions of crowns, which are then ultimately borne by the employer. Thorough training and proper documentation are therefore key to minimising risks when employees work remotely.

LTA NEWS

Our corporate relay team took part in the sixth annual Olga Havel Foundation Run of Good Will and came second out of a total of 65 teams. More than six hundred adult and child runners contributed to help families in need, and we are delighted to be among them.

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