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EDITORIAL

Dear Readers,

This year has been fruitful for businesses in terms of legislative innovations so far... The amended Business Corporations Act has been in effect for half a year. Since 1 June, the oft-mentioned obligation to indicate the beneficial owner has been in force. An amendment to the Construction Act has passed through the Chamber of Deputies, the Whistleblowing Act is being discussed, and the Digital Tax Bill has advanced to the next reading. That is why the latest edition of our newsletter focuses on current case law, interesting judgments and practical experience with the amended laws.

To stay in the loop, I would like to invite you to two upcoming events. The first is the podcast version of second meeting of business owners called #TIMETOLEAD, in which we talk about the future of the Czech economy with guest speaker Miroslav Singer. The other is a seminar entitled New Decisions of the Tax Administration on Family Foundations and Trusts, which is aimed at business owners, family office representatives, and trustees of trusts and foundations, and takes place on 23 June 2021.

I sincerely hope we will have the opportunity to meet at these events. If not, let me take this opportunity to wish you a peaceful and relaxing summer!

Jiří Šmatlák
Partner

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ASSESSING THE FIRST MONTHS UNDER THE SWEEPING NEW AMENDMENT TO THE BUSINESS CORPORATIONS ACT

The extensive amendment to the Business Corporations Act, effective from 1 January 2021, has brought a number of changes with interesting practical implications. Here is a basic overview and our experience with it to date.

Entries of mandatory data in the Commercial Register
One of the novelties is the scope of data that companies are obliged to enter in the Commercial Register. We list the most common data below.

These include the mandatory registration of rights in rem attached to shares. In addition to pledge rights, it is now obligatory to record, for example, information on pre-emption rights or prohibition of alienation or encumbrance. These rights only come into existence (and therefore have the intended effects) upon entry in the Commercial Register.

A similar innovation concerns the registration of information on restrictions on the transferability of registered shares. The amendment links the effectiveness of the restriction on transferability to the entry in the Commercial Register; this applies even if the restriction on transferability is included in the company's articles of association at its incorporation. The previous regulation did not imply such a requirement and the restriction on transferability contained in the articles of association at the company's incorporation was effective without the need to enter this fact in the Commercial Register.

The amendment also brought changes to the registration of a legal entity as a member of a body of another corporation. The legal entity must authorise a natural person to represent it in this body and a new obligation to register this natural person in the Commercial Register has been introduced. This means Commercial Courts will not register a legal entity as a member of a body unless the authorised natural person is also registered. If the natural person is not registered within three months of being elected to the legal entity, the performance of the function ceases by law. This obligation also applies to legal entities who became members of bodies before the amendment came into force and who were obliged to register a natural person by 1 April 2021.

Unless otherwise specified in a particular case, the company is obliged to ensure that the newly entered facts are entered in the Commercial Register no later than 1 July 2021. While we do not expect that the Commercial Courts will strictly apply sanctions, we recommend that everyone bring the entries into compliance with the law.

Profit distribution
The amendment also significantly revised the rules for the distribution of a company's profits. Consistent with an earlier Supreme Court decision, it is now clear that profits may be distributed based on ordinary or extraordinary financial statements up to the end of the fiscal year following that for which the underlying financial statements were prepared. This is proving to be practical and provides greater flexibility for company owners, even when the latest financial statements are already relatively out of date. The amendment thus gives more weight to the so-called bankruptcy test. Although the general meeting may have decided on the distribution of profits in accordance with the law, it is the responsibility of the statutory body to assess, with due care, whether the distribution of free cash flow will not jeopardise the company's solvency.

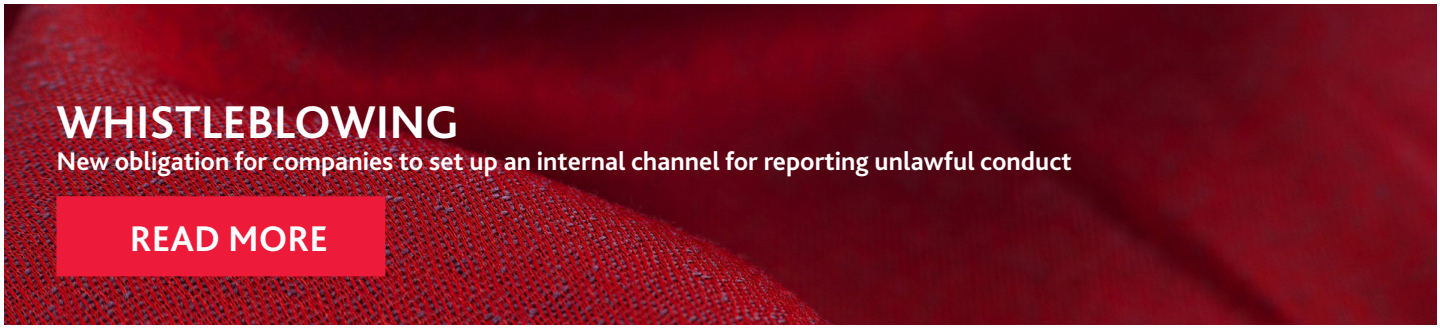
The maximum amount of distributable profits and other equity is now set generally for all companies. Generally, the amount distributable in the company may not exceed the so-called residual profit, i.e. the sum of the profit of the last financial year, the profit of previous years and any other funds, less allocations to the reserve fund and other statutory or voluntary earmarked funds. **The possibility of paying out retained earnings from previous years is therefore also explicitly envisaged, a conclusion that has been reached in practice before.**

Changes have also been made to the treatment of advances on profit shares. The law now provides that the advance is to be returned within three months of the preparation of the financial statements, unless the profit to be paid out based on the financial statements is at least the sum of the advances paid out and the general meeting has decided to pay it out. In such a case, only the advances paid shall be accounted for. It is the statutory body that decides on the pay-out (albeit usually at the instigation of the shareholders) and therefore, here too, the members of the statutory body must assess the advance with due diligence in terms of liquidity and solvency.

Transfer or discontinuance of the plant or part of the assets
Among other things, the amendment to the Business Corporations Act also clarified the conditions under which the assets of a limited liability company or a significant part thereof may be disposed of. This commonly applies to holding or project companies owning a single asset (e.g. shares or stock in another company, real estate, receivables or intellectual property rights). The practical impact is most often seen in financing and securing loans.

According to the amendment, the competence of the general meeting includes the approval not only of the transfer or pledge of enterprise, but also of such part of the assets that would entail a material change in the company's actual line of business or activity. In the case of project companies, such a material change will certainly always be the case when disposing of their only significant asset. In the case of operating companies, the individual assessment may be more complex.

What is certain, however, is that in practice banks and other creditors require such approval as a precautionary measure in principle whenever the creation of a lien on the debtor's or pledgee's property is approved. The consequence of the absence of approval by the general meeting is



the relative ineffectiveness of the legal transaction and the possibility for the shareholders to contest the validity of the security. In addition, in the case of a public limited company, the approval of the general meeting must take the form of a notarial deed, which in our opinion represents an unnecessary expense, especially in the case of single-member companies.

Conclusion
Although the amendment to the Business Corporations Act did not lead to major innovations for most businesses, the change in the legislation has had quite significant practical effects – in our opinion, mostly positive ones. At the same time, we recommend all those who have not yet done so to check their founding legal documents and the status of their registration in the Commercial Register, as the 1 July 2021 deadline for compliance with the amendment is fast approaching.

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INTEREST ON WITHHELD DEDUCTIONS: ANOTHER BREACH OF THE STATUTORY REGULATION BY THE CASE LAW OF THE ADMINISTRATIVE COURTS?

If companies request a refund of the excess VAT deduction, the state (Tax Office) will retain the amount for them in the long term. Since 2015, the tax authorities have granted VAT payers a right to interest under the new provisions of the Tax Code (Section 254a), for which they have examined the justification for the excess VAT deduction (by tax audit or to remove doubts) 1% p.a. plus the CNB repo rate. The amount of this interest was adjusted (increased) in 2017 and 2021. However, as will be explained below, neither interest of 1% (from 2015) nor 2% (from 2017) is regarded by domestic courts as adequate financial compensation for long-term unjustified withholding of VAT deductions.

In July 2020, the vast majority of the professional and lay public in this area took note of a ground-breaking judgment of the Supreme Administrative Court (in the case of EP ENERGY TRADING - file no. 1 Afs 445/2019), in which the First Chamber, with reference to the current case law of the Court of Justice of the European Union, declared the domestic legislation enshrining interest on tax deductions (Section 254a of the Tax Code) incompatible with EU law. According to the Supreme Administrative Court, Czech law does not provide sufficient financial compensation to tax subjects for the fact that these businesses could not dispose of the excessive VAT deduction they reported in their tax returns for an unreasonably long time. The Court states that in accordance with the principle of the neutrality of value added tax, in such a case it is necessary to compensate VAT payers for the economic burden. This represents the interest that a non-credit institution would pay on a loan, typically interest on a business loan. In the present case, the Supreme Administrative Court assessed the amount of interest on the tax deduction pursuant to Section 254a of the Tax Code, as amended from 1 January 2015 to 30 June 2017, in which the Act awarded interest at the CNB repo rate increased by one percentage point. In the judgment, it stated that without much examination, it is obvious at first sight that the current interest paid by non-credit institutions (businesses) far exceeds the statutory interest on the tax deduction under Section 254a. It added that where the domestic legislation is in conflict with EU law, it is necessary to apply the conclusions set out in the „Kordárna" judgment (judgment of the Supreme Court file no. 7 Aps 3/2013), i.e. to award the tax subject interest of 14 percentage points plus the CNB repo rate.

Given that the legislation in question has undergone legislative changes during its existence (since 1 July 2017 and 1 January 2021), primarily with regard to the gradual increase in interest and certain modifications to the interest period, and whereas in the EP ENERGY TRADING judgment the Supreme Administrative Court explicitly dealt only with the wording of this provision from 1 January 2015 to 30 June 2017 (i.e. the said interest of one percentage point), **a question arose among professionals as to whether the amended provision of Section 254a of the Tax Code from 1 July 2017 is already a regulation consistent with EU law.**

We have always been convinced that **even the increase in interest from one percentage point to two percentage points from 1 July 2017 did not remedy the fundamental shortcomings of the Czech legislation in relation to the requirements of European legislation.** That is why we entered into a dispute with the financial administration together with clients who shared our belief, with similar arguments and support in the existing case law of domestic as well as European administrative courts.

On 28 April 2021, a decision was made in our joint case by the Regional Court in Brno, which identified with our legal view of interest on tax deductions as amended on 1 July 2017, and **declared this interest to be clearly contrary to EU law (specifically Article 183 of the VAT Directive)**. The Regional Court based its legal conclusion, as did the Supreme Administrative Court in the EP ENERGY TRADING case, on the recent judgments of the Court of Justice of the European Union (primarily the judgment of 23 April 2020 in Joined Cases C-13/18 and C-126/18 Sole- Mizo and Dalmandi Mezogazdasági). It reiterated that the interest on the withholding deduction must correspond to the amount of interest paid by the non-lending institution. Simultaneously with the reference to the part of the explanatory memorandum to the amendment to Section 254a of the Tax Code, the legislator conceived interest on the tax deduction from 1 July 2017 as financial compensation ranging between interest on deposits and interest on loans. This notion alone suggests that such interest cannot meet EU requirements. At the same time, the court added that in the given period such a low level (repo rate + 2 percentage points) did not correspond to the amount of interest on mortgage loans, i.e. long-term and secured loans.

With its opinion, which can be considered one of the first – if not the first – in this field, the Regional Court ignited a glimmer of hope for truly adequate financial compensation for all businesses that were excessively and unjustifiably withheld excessive tax deductions, even in the period after 30 June 2017 (i.e. after the judgment of the Supreme Administrative Court in the EP ENERGY TRADING case). However, the final conclusion will be reached by the Supreme Administrative Court, which will certainly deal with this issue sooner or later. We are convinced that even interest of two percentage points cannot stand before the Supreme Administrative Court in terms of its compliance with EU law and current case law.

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CURRENT CASE LAW IN THE FIELD OF VAT

The Court of Justice of the European Union (CJEU) has recently delivered two interesting judgments which, in my view, will have a major impact on current administrative practice.

The first is a judgment which changes the perspective on the beginning of the period for correcting the tax base in the event of an irrecoverable claim (Case C-507/20 FGSZ Földgázszállító of 3 March 2021).

The judgment states that if there is a national limitation period for claiming a VAT refund on an irrecoverable claim, that period must begin to run not at the time when the claim is due, but when the claim has become definitively irrecoverable.

Section 46 (4) of the Czech Value Added Tax Act states that the adjustment of the tax base for bad debts, understood as the state refunding the VAT paid to the supplier, cannot be made after three years from the end of the tax period in which the taxable supply took place.

Although it allows the said period to be interrupted, for example, in the case of ongoing execution proceedings, insolvency proceedings, or for the duration of inheritance proceedings, the period is still calculated from the moment of delivery of the goods or provision of the service. This is clearly contrary to the cited judgment.

The judgment addresses the situation where FGSZ filed its claim in insolvency proceedings in 2011 and after the conclusion of this proceeding in 2019, the receivable definitively expired as unpaid. FGSZ subsequently applied for a refund of VAT, which the tax authorities rejected on the grounds that the national five-year limitation period, calculated from the original due date of the claim, had expired in vain.

The CJEU refused to accept a national period which essentially precludes the correction of the tax base, for example because of the length of the recovery procedure, and thus the practical use of that institute of correction of the tax base.

The CJEU recalled that if a Member State has determined that a creditor's entitlement to a reduction in the tax base provided for in Article 90 of the VAT Directive is subject to a limitation period, the relevant limitation period must begin to run not at the time of the original maturity, but at the moment the claim became definitively irrecoverable. The CJEU then added that Article 90 (1) of the Directive fulfilled the conditions required for it to have direct effect.

Although the cited judgment does not address further deadlines for the correction of the tax base, we can assume that even in these cases the opinion of the CJEU would not differ.

An even more significant impact on administrative practice will be the judgment of the CJEU, which deals with the lump-sum sanctioning of unjustified deduction of VAT (judgment C - 935/19 Grupa Warzywna of 15 April 2021).

In that judgment, the CJEU concluded that national legislation which provides for a lump sum penalty of 20% of an unduly claimed deduction is contrary to the VAT Directive and the principle of proportionality, where the parties to the transaction have incorrectly assessed the tax scheme of the transaction and moreover there is no evidence of tax evasion.

In Section 251 of the Tax Code, the domestic regulation of sanctions stipulates, among other things, a lump sum penalty of 20% of the assessed tax liability, regardless of why the VAT was assessed. It can therefore be stated that this sanction is identical to the one on which the CJEU commented.

The Polish company acquired the property and deducted the VAT it paid to the seller. The Polish tax administrator concluded that the contracting parties had incorrectly assessed the VAT regime of the supply in question, as the failure to submit a declaration of waiver of exemption (cf. Section 56 (6) of the Czech VAT Code) involved an exempt transfer of real estate. As a result, the company denied the right to deduct and imposed on it a non-discretionary statutory penalty of 20% of the amount of the unduly claimed deduction.

The CJEU has stated that, in the present case, the penalty is imposed automatically on a taxable person who has incorrectly classified a supply in relation to VAT. This is to ensure that the method of determining it does not allow the tax authorities to assess its amount individually so that it does not go beyond what is necessary to achieve the objectives of ensuring the correct collection of the tax and preventing tax evasion. Such national legislation is then contrary to Article 273 of the VAT Directive and the principle of proportionality.

In essence, the CJEU ordered the tax administrator to consider the way in which the taxpayer reduced VAT when imposing sanctions. Given the wording of the Tax Code, in my view it is possible to use that judgment, for example, in the case of an application for remission of the penalties imposed. As in the previous case, the tax administrator is obliged to accept the judgment of the CJEU in its administrative practice from the date of its issuance.

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TAX NON-DEDUCTIBILITY OF EXPENSES FOR THE REPAIR OF NON-BUSINESS PROPERTY OWNED BY THE TAXPAYER

In its judgment (file no. 8 Afs 204 / 2019-42) of March 2021, the Supreme Administrative Court („SAC") upheld the procedure of the tax administrator, which excluded from tax deductible expenses the costs of repair and maintenance of non-commercial property. What exactly was the judgment about?

As part of the tax audit, the Tax Office assessed the tax to the taxpayer of personal income tax (lessor of a guesthouse and related facilities) for the tax period from 2011 to 2013, from expenses incurred by the taxpayer for repairs, maintenance and operation of real estate (land) included in his business assets, but the taxpayer considered these expenses to be incurred in achieving, securing and maintaining income, thereby reducing the resulting tax base.

The tax administrator concluded that the taxpayer only made the buildings of the guesthouses part of his business assets within the meaning of Section 4 (4) of Act No. 586/1992 Coll., on Income Taxes (the „ITA"). The taxpayer did not prove the registration of the related land. The reclaimed expenses related to the repair, maintenance and operation of these other properties (not included in the commercial property) and were therefore reclassified in accordance with Section 25 (u) ITA as tax non-deductible.

However, the taxpayer argued that there are facilities on the disputed real estate that are used by accommodated clients or are rented together with guesthouses (sports ground, tennis court, sauna, swimming pool, parking, bike shed, ski room). He therefore considered the expenses incurred on these properties to be expenses for achieving and maintaining taxable income. He also supported his reasoning with the content of the website from 2011 to 2013, which shows that the taxpayer also offered services located on the disputed land as part of the accommodation. He also referred to the 2009 tax audit, which did not call into question the expenditure on the repair and maintenance of the disputed land and the cost of the property tax and left the expenditure in question as tax-deductible. The taxpayer further argued that if the expenses related to the property were recorded in the tax records (as evidence he provided copies of data from his books), the property in question is a commercial property.

Judgment of the Supreme Administrative Court
In the context of the described case, the following provisions of the ITA are crucial to assess the tax-deductibility of the claimed expenses.

- **Section 4 (4) of the ITA**
  for the purposes of personal income tax, commercial property means the sum of property values (things, receivables and other rights and valuables) owned by the taxpayer and which have been or are accounted for or are or have been stated in the records of assets and liabilities for the purposes of determining the tax base and income tax.
- **Section 25 (1) (u) ITA**
  expenditures (costs) incurred for achieving, securing and maintaining income for tax purposes, in particular, cannot be recognised as expenses for the personal needs of the taxpayer; including expenses incurred for the repair, maintenance or technical improvement of assets used for business or other self-employed activities, which the taxpayer referred to in Section 2 ITA does not include in commercial assets pursuant to Section 4 (4) ITA.

Therefore, if you, as an entrepreneur, want to classify your assets as business assets, you must start accounting for them or keep them in your tax records („TR"). **However, the SAC emphasised that asset accounting (TR management) does not in itself prove the inclusion of things into commercial property for income tax purposes. What is or is not subject to tax is not determined by accounting regulations, but by the ITA.**

In addition to accounting (TR management), an important criterion for determining the entrepreneur's business assets is also their nature and the way they are handled. The property of a natural person doing business can in principle be of a dual nature: property used for personal needs and property intended for business. **It is therefore necessary to proceed from the principle that commercial property according to the ITA can only be such property of the entrepreneur that is related to his or her business activities and is therefore actually used in this context.**

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MARK IN YOUR CALENDARS: EVENTS AND WEBINARS

We invite you to our professional trainings and meetings where you will get the latest news in tax, finance, accounting, legislation and digitalisation

WEBINAR BDO: WORLD OF PRIVATE CLIENTS

- 23 June 2021, 17:00 - 18:00 - online (in English)

At the webinar, you will learn about the results of the World of Private Clients research report and have the opportunity to listen directly to BDO experts on private clients from around the world. Our speakers from various BDO global offices will discuss the impact of COVID-19 on our key pillars, giving you their insights into the world of private clients and what we can expect in the future.

BDO SEMINAR: CYBERSECURITY - CURRENT TRENDS AND CHALLENGES

- 14 September 2021, 9:00 - 11:30 - Prague

Companies today are facing the challenge of digital transformation, giving rise to new cybersecurity risks. According to experts, cyberattacks are currently the second biggest threat to business after a pandemic. How has Covid-19 affected the work of cybersecurity companies and what are the prospects for the near future? At the online seminar, we will present the results of a survey of the cybersecurity situation in Czech and international companies and suggest possible solutions to minimise these threats.

Lecturer

- Martin Hořický, Partner