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EDITORIAL

Dear Readers,

We are living in a time of turbulent change when nothing can be clearly predicted. Experienced financial analysts see the temptation to deny reality as the biggest danger in such times.

At the beginning of May, the Czech National Bank (CNB) issued a forecast according to which annual **price inflation for 2022 should reach 13.1%,** exceeding the highest level of 13% achieved so far in 1998.

The CNB responded by further tightening monetary policy, which was reflected in an increase in the base repo rate to 5.75%. This is the interest paid to commercial banks on their free money provided to the CNB in exchange for securities that the CNB undertakes to buy back after a set period. In this way, the CNB reduces the amount of money in circulation.

In our everyday lives, the increase in the repo rate will be reflected in particular by the rise in the price of mortgages, the number of which rose to a record high during the pandemic.

How can the effects of inflation be countered? In this situation, is it still preferable to buy a car on credit or is it better to consider leasing? These are questions that many of us are asking ourselves right now.

One of the advantages of leasing is that the risk of inflation is usually borne by the leasing company. Leaseback is then one of the options to obtain the missing free cash. What is a leaseback and how the state administration's view of this transaction has changed in terms of VAT can be found in the article by Petr Vondras.

In his article, Vít Křivánek deals with the issue of interest on late payment in case of additional tax assessment by the tax administrator.

Kamil Vaniš then draws attention to the risk of insolvency, which in view of current price developments and inflation may disrupt the fulfilment of obligations and thus transfer the problem of financial solvency to suppliers. He also gives practical recommendations on how to prepare for the situation and increase the resilience of your company.

I hope you will find this newsletter

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an interesting read and that we will all remain optimistic. This crisis too shall pass and to cope with it we need to remember to stay positive and maintain a good life balance. For some, this can be a renewed focus on hobbies, friends or family, while for others it may be work or rituals that bring a sense of self-fulfilment, but often also necessary changes, without which life would not make sense.

Lenka Lopatová
Partner

NEW TRANSFER PRICING DIRECTIVE

It has been more than three months since the OECD issued a new version of the Transfer Pricing Directive. How has the text of the Directive changed since the last update in 2017?

Based on the information published by the General Financial Directorate, the most important changes can be summarised in the following three points:

- revision of the profit split method, including an annex containing examples of the application of the method;
- a new Chapter X containing guidelines on transfer pricing in the area of financial transactions; and
- a new Appendix to Chapter VI on the application of the approach to intangible assets that are difficult to measure

I consider it important to become more familiar with these changes, especially for Czech entities that have been mandated by a multinational group to undertake research and development of new intangible assets or to provide intangible assets created by them for further use within the group. For such companies, the profit split method might be an appropriate way to determine the price in related party transactions.

Revision of the profit split method

The objective of the profit split method is to distribute the profit among the entities involved in the transaction in a way that most fairly reflects the added value each of them has contributed to the common goal. It is not without significance that the profit split method can be applied to the allocation of losses in the same way as to the allocation of profits.

The Directive does not contain any prescriptive rules to help identify the cases for which the profit split method is most appropriate.

The advantage of the profit split method is the ability to resolve cases where each of the parties contributes to the transaction in a unique and valuable way. A limitation to the use of this method may be that it requires knowledge of the consolidated result of the entire transaction. In many cases, it is difficult to extract from accounting records maintained under different laws the costs and revenues incurred by all the entities involved in transactions leading to a common objective in a way that would enable the profit to be identified with sufficient reliability to be distributed as remuneration for the functions performed and the assets involved.

According to the Guidelines, one key that may be used for profit split purposes is the time spent by experienced professionals on a transaction resulting in a unique intangible asset. However, this assumes that there is a linear relationship between the amount of this time effectively spent and the value of the asset being developed. Closely related to this issue is also the new Annex to the Directive on the treatment of hard-to-value assets.

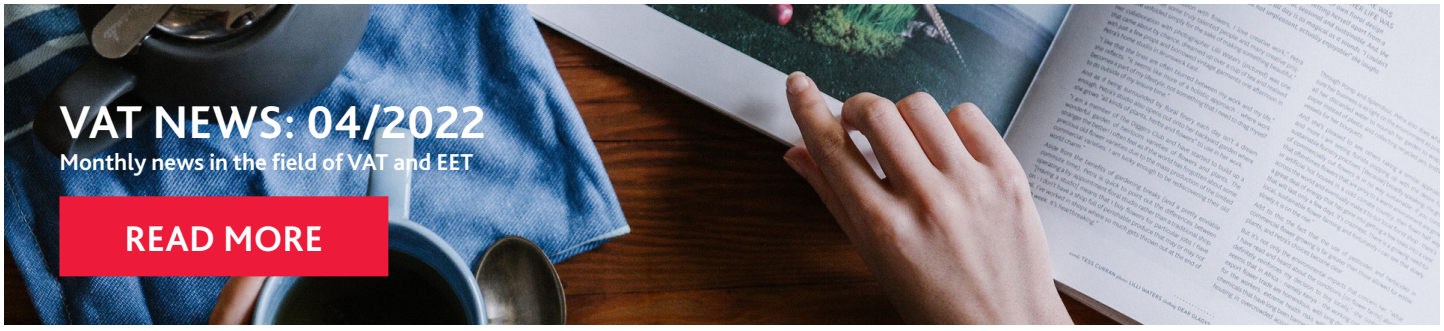
For the profit split method to be used effectively, contractual arrangements are needed that define the rules under which the profit will be split, as well as the duration of these rules. **And it is written contractual arrangements clearly defining the set rules for pricing between related parties that are often forgotten in practice.** The absence of written contractual arrangements often leads to a lack of evidence in the event of a tax audit, which may result in an additional tax assessment.

New Chapter X of the Directive

Czech entities that benefit from intra-group financing such as cash pooling should pay particular attention to the new Chapter X of the Directive containing guidelines on financial transactions. Chapter X contains a description of the stricter rules for testing financial costs and benefits linked to short-term intra-group financing transactions. Short-termism is essential in cash pooling transactions. The average interest rates at which banks in the Czech Republic lend money to each other on the interbank market can be used to test the interest rates associated with cash pooling transactions. Such a rate is, for example, 3M PRIBOR.

The evaluation of the test results is based on the circumstances in which the financial transaction was negotiated. In the case of a cash pooling transaction, the desire for synergistic use of cash within the group is taken into account, one of the main advantages being easy access to a source of funding. A market-clearing interest rate is considered by the profession to be a situation in which the cash pooling borrower's interest rate is no higher than the rate that would have been negotiated with a banking institution. The cash pooling lender's rate, on the other hand, should be higher than what the bank would have offered for the funds provided.[1] Otherwise, the use of cash pooling would not provide the expected benefit/reward to all entities involved, including the entity responsible for maintaining the master account.

In a market environment, the amount of interest is determined by an agreement between the two parties which, among other things, reflects the risk of the debtor's insolvency. The rate at which the bank obtains the deposit in the interbank market is increased by this risk premium. According to the CNB's forecast published on 5 May 2022, the three-month PRIBOR rate could reach 7% in 2022. **In the case of interest rate settings for intra-group financial transactions such as cash pooling, it is essential to monitor the rapidly changing rates on the interbank market.**



Cash pooling operations may be subject to mandatory reporting, the scope of which is set by the CNB in a decree.[2] This obligation may apply, for example, to companies whose annual volume of financial loans granted or received in relation to foreign countries at the end of the calendar year reaches CZK 100 million.[3]

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1 Chamber of Tax Advisors e-Bulletin 5/2022

2 Decree 235/2013 Coll.

3 Act No. 219/1995 Coll.

ARE YOU PREPARED TO MANAGE THE RISKS ASSOCIATED WITH THE GROWING INSOLVENCY OF YOUR CUSTOMERS?

Theextreme pressure of current events on firms significantly increases the likelihood that some of them will be unable to meet their obligations. In particular, the sharp rise in input prices (12.7% year-on-year increase in inflation in March 2022), the slowing growth rate of the Czech economy (forecast growth of only 1.2% in 2022), record energy and fuel prices, the sharp rise in input prices on commodity markets and shortages, whether due to the economic impact of the COVID-19 pandemic or the unpredictable development of the war in Ukraine, are impacting corporate financial health. In this context, many companies will also be affected by the de facto impossibility of repaying loans secured by COVID mechanisms (some of which will mature during 2023).

While current statistics do not yet paint a dire picture, a significant increase in insolvency can be expected in 2022 and 2023.In the first quarter of this year, 286 insolvency petitions were filed by commercial companies (6% more than in the comparable period last year) and 1,435 insolvency petitions were filed by individuals.
Some insurers are expecting a significant year-on-year increase in insolvencies of up to 30% this year.
Surveys of insurance companies indicate a higher proportion of unpaid invoices. Data from claims insurers also show that only a small proportion of claims more than 90 days past due are usually paid.
Early identification of the problem and an adequate response to the borrower is crucial for the lender. The success of debt recovery often depends on how much time has elapsed since the due date of the debt. **The following are simple principles that contribute significantly to the proper management of receivables through in-house processes. These principles should be formalised within the company, e.g. in the form of an internal directive.**

Evaluation of customer creditworthiness

- Take the time to check the financial stability of potential business partners before committing to an order.
- Create collaboration within the company between financial specialists and salespeople to finalise terms of business.
- Set appropriate payment terms and performance milestones to reflect the identified risks. It is appropriate, for example, to divide the contract into sub-parts with staged payments, advance payments, purchase of part of the inputs to the contract directly at the customer's expense, use of bank guarantees, guarantees for payments by a third party, securing part of the payments with a lien, etc.

Standardisation of the process of managing overdue receivables

- Designate a lead coordinator (credit & collection specialist/ manager) with a link to the management of the debt management and collection company, whose priority agenda is the management and overall coordination of the debt collection process, reporting, etc.
- Divide the debt recovery into several escalation stages, e.g. the first attempt at recovery is carried out by the salesperson / key account manager, in the next stage a dunning letter is issued in writing by the coordinator and the third stage is handled in cooperation with a legal specialist.
- Standardise the documents or templates used for written communication and set regular deadlines for checking the status of claims, sending out dunning letters and coordinating critical cases.

Properly maintained accounts receivable records

- Maintain accurate accounts receivable records. In the case of debt collection, you must document not only the amount of the claim, but also keep documents proving the legitimacy of the claim (contracts, delivery notes, etc.).
- Set up regular reporting of receivables, highlighting overdue receivables with a clear indication of potential risks. This report must be available to salespeople, key account managers, etc.

Timely resolution of critical cases

- Clear overdue debts at an early stage without delay. You can gradually escalate collection from a reminder, acknowledgement of the debt owed by the customer to your company, applying a contractual penalty for late payment, making further delivery conditional on payment (if contracts allow), proposing a payment plan, etc.
- Require collateral for overdue receivables, e.g. a third-party guarantee (e.g. a sister company, parent company), collateral in the form of a pledge of the company's assets (which may be movable, immovable, patent, receivable, etc.) or collateral in the form of a promissory note with a direct enforceability clause.
- Consult early on critical cases with specialists who will be competent to manage the risks in the process of recovering your debts in or out of court.

The current economic climate brings with it higher risks of insolvency of companies directly or indirectly affected by sharp increases in input prices. For these situations, it is advisable to strengthen receivables management processes.

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THE DEFAULT INTEREST LIMIT THAT NOBODY KNEW ABOUT

Interest on late payment, accessory tax, a legal penalty affecting all those who fail to meet their tax obligations on time. Interest on late payment also plays an undeniable role in the case of an additional tax assessment by the tax administrator. The period of delay is calculated from the original due date of the tax, i.e. from the date on which the deadline for filing the tax return for the tax period

for which the tax administrator is assessing the tax expired. As an illustration, the taxpayer will be in default in the assessment of value added tax for the January 2013 tax period from 25 February 2013 until the moment when the taxpayer pays the outstanding tax.

The period of delay can exceed six or seven years in a normal situation. This is determined by when and for how long the tax authority conducts the tax audit. As a rule, the tax inspector will start the tax inspection before three years have elapsed from the end of the tax year in question, and the inspection will be conducted for two to three years. The taxpayer then goes on to appeal against the assessment decision and only then, in most cases, does the payment of the tax due come into play.

The amount of interest on late payment, which is also linked to the development of the repo rate, has undergone only one parametric change since 2011, i.e. since the Tax Code came into force. From 2021 onwards, the amount of interest has been reduced from 14% to 8%. Until recently, the tax administrator based its calculation of interest on late payment on the above assumptions, i.e. it determined the length of the delay and applied the appropriate interest percentage. As it turned out, however, for taxes whose original due date fell within the period until 31 December 2014, the tax administrator should have considered another parameter: the limitation of the maximum length of delay.

In its judgment under case No. 7 Afs 351/2019 in 2021, the Supreme Administrative Court dealt with whether the interest on late payment of taxes where the deadline for filing returns expired before the end of 2014 (e.g. income tax for 2013 and earlier, VAT for November 2014 and earlier) should be „capped" according to the then applicable law (Section 252 (2) of the Tax Code) at a maximum of five years. In doing so, the Court concluded that there was no legal reason why interest on late payment in respect of these taxes should not be subject to the limit in question.

As a minor historical note, it may be added that the same delay limit was also contained in the Tax Administration Act effective and in force until 31 December 2010 (the predecessor of the Tax Code).

It is almost surprising that the statutory „capping" of interest on late payment was not „discovered" until 2021. If the Supreme Administrative Court had not addressed this issue, it is likely that no one would have ever known about this limit, which was in force only until 31 December 2014 (the amendment of 1 January 2015 deleted this part of the Act).

Does the Supreme Administrative Court's conclusion have any positive impact for us, since these are such old tax periods? It may. There are still proceedings pending today on these taxes, albeit at the administrative court stage, for example. The period during which it is still possible to do something about the amount of interest is quite long (six years).

If you have been assessed tax by the tax administrator for one of the above-mentioned tax periods and the length of the delay was more than five years, there is still a real chance to reduce the resulting amount of interest, even by hundreds of thousands of crowns.

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LEASEBACK IS NOT A DELIVERY OF GOODS, GFD AGREES TO CHANGE ADMINISTRATIVE PRACTICE

Three years after the court's ruling in the Mydibel case, the tax administration is no longer accepting the historical interpretation relating to leaseback. The change has tax implications for both lessors and lessees.

A leaseback is considered to be a situation where the owner of the item sells it to a leasing company from which the original owner will subsequently reacquire the item in the form of a finance lease, i.e. in instalments with a final purchase after an agreed period. Prior to April this year, the administrative practice was to treat the sale between the original owner and the leasing company as a delivery of goods followed by the formal handover of the item to the original owner for use by the leasing company. Both were treated as taxable supplies of goods. **This settled administrative practice was affected by the Mydibel judgment, according to which the sale of an item from the owner to the leasing company is not a supply of goods because the item remains in the possession and therefore in the economic ownership of the original taxpayer.** The leasing company does not acquire economic ownership of the item by purchase, but merely enables the seller to obtain the funds. For this reason, according to a recent opinion of the Czech General Financial Directorate, the transaction in question has the character of a financial service at the level of a loan.

Given that financial services are exempt from VAT without the right to deduct, the change would have a major impact on ongoing leaseback transactions. If a sale from the owner to a leasing company was not to be treated as a supply of goods for VAT purposes, then a subsequent finance lease cannot be treated as a supply of goods either. And if neither transaction is a taxable supply, neither supply can be claimed as a deduction, even if VAT is shown on the tax invoice. And that would already be a significant financial hit.

Fortunately, the General Financial Directorate has agreed to the proposal of the Coordination Committee's drafters that **leaseback will be considered a financial service only for contracts concluded after 29 March 2022.** For contracts concluded before then, it will be possible to consider both supplies, i.e. from the original owner to the leasing company and from the leasing company to the original owner, as taxable supplies of goods for which a deduction is claimed. The condition is that both parties to the contract do so.

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▶ 1 June 2022

The Whistleblower Protection Act, which transposes the EU Directive, was supposed to come into force on 17 December 2021. However, the Chamber of Deputies passed the bill late and the Directive was not implemented on time. What does this mean for businesses and organisations? This seminar will present effective solutions to manage these challenges and minimise the regulatory and reputational risks outlined above. We will also describe how to make the most of the new obligations for the benefit of the company or how to link whistleblower protection with existing ESG frameworks.

Lecturer

- Stanislav Klika, Head of Risk Advisory Services

BUSINESS BREAKFAST: THE TREND OF ERP MIGRATION TO THE CLOUD

▶ 22 June 2022

In cooperation with Amazon Web Services and Infor, we have prepared a Business Breakfast on current IT trends. Together we will discuss the benefits and pitfalls of putting ERP systems in the cloud. We will present solutions to minimise the risks of cloud solutions, how to address the main concerns of management, and how to ensure the security and agility of the software. We will summarise what factors not to forget when making a decision and what criteria to consider when selecting ERP in the cloud.

Lecturers

- Tomáš Kubíček, Partner
- Tibor Kolejak, Country Leader Amazon Web Services
- David Zeman, Sales Manager SEE Infor

SEMINAR: SUSTAINABLE BUSINESS, ESG STRATEGY AND GREEN FINANCE

▶ 23 June 2022

Green Deal for Europe, Fit for 55, taxonomy, NFRD, CSRD, SFRD, ESG... Have you heard these terms before but are not sure what they mean? Would you like to know how these new obligations will affect your business? Are you wondering how to make the most of them for your business? Or would you just like to do business responsibly and are considering what approaches to take? Find out where your business stands in terms of sustainability factors with an ESG rating.

Lecturers

- Lucie Johaníková, Partner
- Stanislav Klika, Head of Risk Advisory Services
- Ondřej Veselovský, CRIF - Czech Credit Bureau

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