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dReport: December 2018

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Current Situation as Regards the Tax Package Approval Procedure

The second reading of a bill amending various tax laws (the so-called Tax Package, Parliamentary Document No. 206) is to be included in the programme of the 24th session of the Chamber of Deputies, taking place from 4 December 2018.

As we have already informed you in previous issues and in our regular webcast, it is unlikely that the original bill will be passed by the year-end. The possible effect of changes specified in the original bill is being addressed at present. The motions to amend which have been considered and are available on the website of the Chamber of Deputies (the deadline for their submission was 14 November) do not clearly indicate a comprehensive approach. The Ministry of Finance is preparing and debating (for example with the Chamber of Tax Advisors of the Czech Republic) a proposal for postponing the effective dates of individual provisions, with the preliminary indication that selected changes would only come into effect after the Act has been passed (or from the next month following the publication in the Collection of Laws), with other ones becoming effective for the next taxation periods subsequent to the Act taking effect. We have been closely monitoring the latest developments. A summary of details concerning the Tax Package (including the effective dates of relevant provisions) will be published after the second reading.

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Possible Changes in the Real Estate Acquisition Act

The Czech Pirate Party has prepared a draft amendment to the ordinance on real estate acquisition tax which, if approved, would decrease the tax rate on the acquisition of real estate for natural persons purchasing real estate for own permanent residence and eliminate the possibility of claiming an exemption for new buildings by legal entities.

The first substantial change proposed by the deputies in the amendment to Ordinance of the Senate No. 340/2013 Coll., on Real Estate Acquisition Tax, relates to the exemption of the first transfer of a new building in exchange for consideration. At present, both natural persons and legal entities are entitled to the exemption, provided the property meets the statutory parameters of a new building. If the amendment is approved, the exemption could only be newly applied by acquirers that are natural persons, and EU and EEA nationals. According to the proposers, the amendment's objective is to prevent the existing practice whereby legal entities purchase new buildings and subsequently only sell equity interests in the given business corporations, which are not subject to real estate acquisition tax. The amendment should ensure that the legal entity pays real estate acquisition tax at least upon the first acquisition of the new building.

Secondly, the draft amendment proposes that the tax rate on real estate acquisition be decreased from 4% to 2% for tax bases under CZK 4 million. In excess of the limit, the standard 4% tax rate would continue to apply. The draft amendment proposes several conditions for applying this treatment: the decreased rate could only be applied by natural persons of age who are acquiring the whole property or an ownership interest equal to at least half of the property and who are not owners of another property in the Czech Republic or in another country as of the date of property acquisition, either directly or indirectly, for example, through a legal entity. The property must be intended for residence and, as of the date on which the deadline for filing the tax return expires, they must have permanent residence in the property. The latter condition is the weakest point of the draft amendment. In practice, if a natural person wanted to apply the decreased rate, he or she would have to relocate its permanent residence to the newly acquired property no later than within three months from the registration of the ownership right in the Land Register.

Another controversial restriction for applying the decreased rate is the five-year conditionality of the exemption: if the taxpayer gratuitously transfers his or her ownership

right to the property within five years from its acquisition, the entitlement to apply the decreased rate will expire and the taxpayer will be obliged to pay the remaining portion of the real estate acquisition tax at the standard 4% rate. Gratuitous transfers also include allocating the property to a trust fund. The restriction clearly targets the situations where the decreased rate would be abused for speculative purposes. However, neither the draft amendment nor its explanatory report specify the treatment of, for example, the settlement of marital property or divided co-ownership, which may occur on fully objective grounds.

At the moment, it is difficult to predict whether the amendment will find support in the legislative body. At its meeting of 24 October 2018, the government expressed a negative opinion. The draft is now set to be debated by the Chamber of Deputies. We will, of course, keep you informed about the course of the legislative proceedings.

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Ruling: Correction of Accounting Errors and Tax Base Implications

This article summarises the key information arising from judgment 3 Afs 28/2017 – 43 which was issued in October 2018, addressing two areas as follows: corrections in accounting records including implications for a corporate income tax return ("CITR") and insurance benefits in relation to an assigned receivable. A cassation complaint of the Appellate Financial Directorate ("AFD") against Československá obchodní banka (the "Company") has been rejected.

In 2008, the Company made corrections of its accounting records for a period of 2000-2005 (the aggregate amount of corrections of income and expenses was booked in 2008). These corrections were not reflected in the 2008 CITR; nevertheless, the Company filed additional CITRs for 2001-2004 (no additional CITRs were filed for 2000 and 2005 as these years were considered lapse periods). However, the Tax Office included the income in the 2008 tax base, without reflecting the related expenses in the tax base for the same year. According to the AFD, the Company failed to demonstrate that the expenses of the 2000-2005 taxable periods had not been booked in prior periods which is why the tax authority did not reflect those expenses in the 2008 CITR.

The Supreme Administrative Court ("SAC") ruled that the tax authority cannot request the income/expenses to be reflected in the tax base for the taxable period in which the accounting correction was made provided that the income or expenses relate to another taxable period. Furthermore, it is irrelevant that tax can no longer be additionally assessed for that taxable period because of a lapse of claim.

The judgment implies that if a retrospective correction was made in the accounting records due to an error, this would not affect the tax liability for the year in which the error was identified. We would like to note in this context that this involves corrections of errors made by mistake rather than deliberately to postpone the tax liability.

In addition, the Company provided a loan which was insured against risk at Exportní garanční a pojišťovací společnost ("EGAP"). An insured event occurred in 2003 (the receivable became uncollectible). Since that year, EGAP has paid out insurance benefits to the Company in an amount corresponding to the repayments of the original loan, as defined in the agreement concluded with the Company. Concurrently, the original receivable was gratuitously assigned by the Company to EGAP. In 2008, the Company recorded in its accounting records a receivable from EGAP, with the instalments recognised in the balance sheet as a decrease of the receivable's value. Nevertheless, from the tax authority's perspective, the Company concluded with EGAP an insurance rather than re-insurance contract for which reason Section 77 (a) (1) of Regulation 501/2002 Coll. does not apply and Section 27 of Regulation 500/2002 Coll. is used instead. As a consequence, insurance benefits should be recognised as income (not in the balance sheet).

It may be inferred from the SAC's ruling that differentiating between insurance and re-insurance is rather insignificant. The tax base cannot be determined solely based on accounting regulations. The tax authority cannot additionally assess income tax based on the mere assertion that the accounting records of a company do not comply with its statements without concurrently providing convincing evidence of the true nature of the transaction and, accordingly, its tax deductibility in the respective reporting period.

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GFD's New Guidance Note on the Binding Assessment of Transfer Pricing and the Method of Determining the Tax Base for Permanent Establishments

On 9 November 2018, a new guidance note, D - 32, of the General Financial Directorate ("GFD") was published in the Financial Bulletin of the Ministry of Finance on the binding assessment of the pricing method between related parties and the method of determining a tax non-resident's tax base on activities performed through a permanent establishment (hereinafter jointly as the "binding assessments").

The new guidance note replaces Guidance Note D – 333 and, besides changes relating to the binding assessment of pricing between related parties under Section 38nc of the Income Taxes Act, it also newly incorporates information on how to proceed during a binding assessment in assessing the determination of a tax non-resident's tax base on activities performed through a permanent establishment under Section 39nd of the Income Taxes Act, which was introduced as early as 1 January 2018, yet in respect of which no accompanying methodology has been issued so far.

Although the guidance note is not legally binding, it serves as a clue for tax payers as to how the tax administration will address the issue of transfer pricing between related parties and the determination of the tax base/tax loss in respect of permanent establishments.

Shortening the Deadline for Filing an Application

A major change introduced by Guidance Note D – 32 in respect of binding assessments is the clarification of the deadline for filing the binding assessment application. In line with the previously applicable guidance note, it was possible to file the binding assessment application both during the taxation period for which it was being filed as well as subsequent to its expiry until the deadline for filing the tax return for the period. The new guidance note clarifies the interpretation of the deadline for filing the binding assessment application in that, with effect from 1 January 2018, binding assessment applications may only be filed for the taxation period during which the application is filed and for the subsequent taxation periods.

The change may have a significant impact on applications filed subsequent to 1 January 2018 in compliance with the rules stipulated by the replaced Guidance Note D – 333. However, it still applies that in situations where the payer used the same transfer pricing method or method of attributing profits to a permanent establishment in the preceding periods under corresponding terms, it may be assumed that if an affirmative ruling is issued, the tax administrator will, despite the invalidity of the ruling for prior periods, proceed similarly during tax audits as if the binding assessment had been issued.

Who are the Applications to be Submitted to and who Issues the Binding Assessment Ruling?

The new guidance note also specifies that taxable entities must submit binding assessment applications to the locally competent tax administrator. The application will be examined either by the locally competent tax administrator or the General Financial Directorate depending on the number of domestic entities to which the binding assessment relates. If the application exclusively relates to payers falling within the competence of a single locally competent tax administrator, the ruling will be issued by the respective tax administrator. If the payers in respect of whom the ruling is issued fall within the local competence of multiple tax administrators, the application will be examined by the General Financial Directorate. The same procedure will apply to bilateral or multilateral advanced pricing agreements.

Uncertainty about the Issuing of Rulings Persists

However, the new guidance note fails to eliminate tax payers' uncertainty regarding the deadline for issuing binding assessment rulings as the tax administrator's deadline for binding assessments has not been clarified or determined in any way.

The Administrative Fee Depends on the Number of Transactions or Permanent Establishments

The administrative fee for accepting applications is not newly fixed at CZK 10,000 per application: its amount will depend either on the number of transactions or permanent establishments assessed.

Assessing a Set of Unrelated Transactions

In respect of the binding assessment of transfer pricing between related parties under Section 38nc of the Income Taxes Act, major changes include the approach to assessing a set of closely unrelated transactions with related parties. Pursuant to the previously applicable guidance note, if the tax administrator had issued a negative ruling, the rejection

of the application only related to the application itself, ie to all assessed transactions contained therein. Newly, the tax administrator will assess each transaction from among the set separately, independent of the others, with rulings issued on each transaction. These may be affirmative or negative regardless of the ruling on other transactions. The change in determining the administrative fee is also related to this update.

Assessing the Determination of the Tax Base in Respect of Permanent Establishments

With effect from 1 January 2018, Section 38nd of the Income Taxes Act also introduced a "binding assessment of the method of determining a tax non-resident's tax base on activities performed through a permanent establishment". Therefore, Guidance Note D – 32 specifies the methods for this type of binding assessment. In assessing the tax base for permanent establishments, the methods are similar to those in assessing transfer pricing. The primary basis are the tax non-resident's accounting books (tax records), with the tax base customary for tax residents in a similar situation taken into consideration. In determining the tax base, Section 23 (11) of the Income Taxes Act and Article 7 of the respective Double Taxation Treaty are applied, as are the general principles stipulated by the 2010 OECD Report on the Attribution of Profits to Permanent Establishments.

The assessment application must always be filed by the tax non-resident that has formed or will form a permanent establishment in the Czech Republic. If the tax non-resident generates profit in the Czech Republic through multiple permanent establishments whose activities are unrelated, each of them is separately assessed. However, if the activities of permanent establishments are inextricably linked, only one application may be filed and the permanent establishments will be jointly assessed. However, the administrative fee is again charged in a corresponding amount.

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The Court's New View on the Utilisation of Clinical Studies as Part of the R&D Deduction

The Supreme Administrative Court (the "SAC") has found against Vestra Clinics s.r.o. (the "Plaintiff") in the matter of the possibility of utilising clinical studies as deductible items for research and development ("R&D"). Although the Court confirmed that clinical studies do meet the definition of R&D (as is, after all, indicated in Guidance Note D-288 and the Frascati Manual), the SAC ruled that the Plaintiff's activities constitute the following of clearly defined instructions as prescribed by the clinical trial report, without containing any elements of novelty or clarifying scientific uncertainty.

The Court identified the elements with the clinical trial ordering party – the producer of the pharmaceutical – rather than with the Plaintiff. The SAC concludes that the Plaintiff merely carried out a specialised service for the ordering party: it did not bear the economic risk of the tested pharmaceuticals' failure or affect the instructions, course or conclusions of the clinical trials and thereby did not meet the conditions for utilising the R&D tax deduction.

The Plaintiff, as a non-governmental health-care facility (a CRO), performed Phase-3 clinical studies, ie the systematic testing of pharmaceuticals on patients with the aim of demonstrating and verifying their curative effects and identifying any undesirable effects. In doing so, the Plaintiff is not an entity developing the pharmaceuticals: the ordering party (a pharmaceutical company) only makes use of its technical facilities and the high level of expertise of its employees (physicians) in order to carry out this development phase.

Following an analysis of the Pharmaceuticals Act, the SAC concluded that clinical studies are, generally by their very nature, activities that may be subordinated under R&D as they comprise the two defining traits of R&D – the existence of an element of novelty and clarification of scientific uncertainty. However, the SAC added that for the activities to be utilisable as part of the R&D deduction, the negative condition stipulated by the Act must also be fulfilled: ie, that the activities carried out in implementing the project must be performed by the payer itself rather than purchased as a service.

What the Frascati Manual and the Horizon 2020 Programme Say

According to the SAC, the actual research activity was performed by the ordering party (the pharmaceutical company), with the ordering party having developed the pharmaceutical, including the instructions according to which the testing phase was carried out by the Plaintiff. Therefore, as the Court ruled, the Plaintiff did not carry the increased level of business risk – it was borne by the ordering party. If the result of the clinical trial had been negative, the development of the pharmaceutical would not have proceeded to the next phase: ie, the pharmaceutical

would not have been produced. According to the SAC, in this situation, the risk investment made by the clinical trial ordering party, rather than that of the Plaintiff, would have been marred.

The SAC thus refused to regard the clinical trial of a pharmaceutical performed by a CRO to constitute an independent R&D project whose input is a new active substance and the deliverable includes new findings on its actual effectiveness and safety. In its ruling, the SAC states that it regards clinical trials of pharmaceuticals to be eligible for a deduction only in relation to the development and subsequent commercial use of the pharmaceuticals as part of a single project. This is despite the fact that, globally, clinical studies are, as a rule, conducted by CROs (instead of pharmaceutical companies), which is also true of the Czech Republic.

Given this fact, it may be inferred that the authors of the Frascati Manual (the OECD's underlying document for identifying R&D activities) as well as, say, the authors of the documents for the Horizon 2020 programme – the principal EU programme supporting R&D activities (where the documents expressly state that Phase 1-3 clinical studies meet the definition of R&D) based the documents on the fact that clinical studies are, as a rule, carried out by CROs rather than pharmaceutical companies themselves. It may also be inferred that in preparing Guidance Note D-288, lawmakers based their work on the Frascati Manual and, as a result, made it possible for Phase 1-3 clinical studies to be utilised in a deduction as they meet the definition of R&D (which, after all, the SAC confirms).

Considering countries that have included the R&D deduction in one form or another in their legislation, you will find that the legislation of many of the countries (eg, France) makes it explicitly possible to utilise specialised activities and costs incurred on Phase 1-3 clinical studies as part of the deduction. In view of the matters outlined above, it is evident that the lawmakers or authors of the documents were interested in supporting the activities and were aware that not all phases preceding the roll-out of a new pharmaceutical are typically performed by a single entity. Subsequently, it is not relevant which entity implements this phase of clinical studies and whether it is implemented independently or as part of a greater whole (eg, along with the development of the pharmaceutical).

Who Carries the Business Risk?

In the case in hand, the result is a situation where, on the one hand, it has been confirmed that clinical studies constitute R&D, but, on the other hand, an argument is put forward referring to the use of "risk capital" during the product's development and its indivisibility from the whole being developed. However, it would be a mistake to assume that the Plaintiff did not carry the risk of a business failure. Its risk capital does not consist of the costs of bringing the development of the pharmaceutical into Phase 3, but, from its perspective, if it had selected inappropriate patients, carried out an erroneous analysis and made an incorrect expert assessment of the effects of the pharmaceutical administered by the physician, or selected and used inappropriate assessment methods, the investment would have been marred considering the costs incurred. At this point, it should be noted that while the Plaintiff's business risk does not consist of the failure to roll out the pharmaceutical, it would be at risk of losing a contractual partner and its professional reputation on the market if it made an error during the clinical research into the pharmaceutical's effectiveness and safety.

If the situation is misread, there is a risk of generalising the conclusions and applying them, say, to the automotive industry, whereby it could be asserted that if the payer only develops a certain component for a brand new engine, it does not bear the business risk of the failure of the entire item being developed (in this context, the engine). However, in business practice, it is entirely customary that multiple entities gradually participate in the development of a single whole, with by far not all of them bearing the business risk of achieving the target parameters. However, the situation described clearly shows how sophisticated the product or process being developed is. Distinguishing chains of development phases and assessing them from the business risk perspective could, in practice, result in the restriction of using the institutes of a deductible item by a whole series of firms performing undisputed R&D activities.

A Surprising Interpretation Given the Existing Legislation

In respect of the argument of acquiring the activities as a service, which is not, from the perspective of law, a tax deductible expense, it can also be objected that the interpretation is outside the boundaries of the existing legislation. By defining the impossibility of including a purchased service in R&D, the lawmakers had a completely different situation in mind: if the pharmaceutical company purchased the results of the Plaintiff's work, the purchase would not be tax-deductible on the pharmaceutical company's part. However, in this context, the Plaintiff did not purchase the service: it supplied it itself in the form of new expertly acquired findings which the ordering party ordered from it, as is customary in the industry.

Through this ruling, the SAC presented its view on the eligibility of R&D activities for a deduction, concluding that the Plaintiff lacked both the possibility of creatively affecting the instructions, course and assessment of the clinical trials, as well as the elements of novelty and business risk connected with testing a proprietary pharmaceutical.

The authors of this article believe that the ruling brings new insight into the definition of R&D activities eligible for a deduction which does not, however, decrease tax payers' legal uncertainty. With regard to utilisation, the results of Deloitte's latest survey indicate that uncertainty arising from ambiguous conditions of this aid constitutes the most significant barrier for almost 60% of businesses.

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Amendment to the VAT Act

As we have already informed you, the debate on the amendment to the VAT Act has been delayed and the relevant changes could become effective on 1 April 2019 at the earliest (instead of the originally anticipated date of 1 January 2019). In addition, a series of revisions have been submitted in relation to the amendment, which could further complicate the debate (these most frequently include proposed amendments to the application of VAT rates). At the same time, the signals that the existing VAT treatment should be preserved in respect of bonuses to statutory executives and members of statutory bodies have been ever greater.

Let us hope that as this dReport issue goes to press, the debate about revisions will have been concluded and the wording in which the amendment will enter the third reading in the Chamber of Deputies will be clear.

Reverse-Charge Extension

Starting from 1 January 2019, the VAT Directive was supposed to make it impossible for member states to apply selected reverse-charge treatments (eg, to trading in industrial crops or selected computer technology). However, the Council of the EU has adopted an amendment that also makes it possible to apply the reverse charge in the years to come (until the expected transition to the "Definitive VAT Regime").

Rulings of the CJEU

In Case C-502/17 C&D Foods Acquisition, the Court of Justice of the EU ("CJEU") ruled on how to treat the holding of equity interests in a subsidiary. The parent holding company did not provide any supplies to it (eg, in the form of management services), yet it provided such supplies to a "sub-subsidiary". The CJEU's ruling clearly shows that the holding of an equity interest in a subsidiary does not constitute an economic activity in terms of VAT regulations.

In Case C-495/17 Cartrans Spedition SRL, the CJEU described the treatment of export-related services. The CJEU did not depart from the direction implied in earlier judicature, yet it additionally clarified what evidence may be used to prove exemption. In our view, the ruling also substantially affects the interpretation of exemption pursuant to the Czech VAT Act.

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Hard versus soft Brexit. What will the divorce agreement with the EU bring?

The time of the withdrawal of Great Britain from the EU is inexorably approaching and the issue of Brexit has become a frequent topic of discussions. Although the political process regarding Britain's withdrawal from the EU has not come to an end yet, let's summarise the alternative scenarios and their possible impact.

Approval of the EU Divorce Agreement or "Soft Brexit"

In the past few days, the content of the agreement was finalised at last and approved by the British cabinet. However, it is still to be approved by the British Parliament and the result is far from being certain. The British Parliament should deal with the issue before Christmas. The agreement is also to be approved by the European Parliament.

The EU divorce agreement includes a transition period, which shall last until 31 December 2020, and which shall provide companies and individuals as well as state institutions with time to prepare for the final Brexit. The final relationship between the EU and Great Britain after the end of the transition period will be subject to a separate agreement.

During the transition period, Great Britain will continue to be a member of the customs union and the EU single market. Thus, no significant changes will occur for Britain from the perspective of customs and VAT, all the transactions will be Intra-Community transactions. During the transition period, Britain will not be able to apply its newly agreed deals or rules in areas governed by the EU.

Non-Approval of the Agreement with the EU or "Hard Brexit"

If the divorce agreement between Great Britain and the EU is not approved, Great Britain will leave the EU on the night from 29 March 2019 to 30 March 2019 under circumstances referred to as "hard Brexit". Under such scenario, Great Britain will be considered a third country with no custom concessions. All the imported and exported goods will be subject to standard customs procedures, including customs duty assessment. Further impacts are expected in the area of the origin of goods or matters related to the necessity to provide import/export licenses for certain groups of products.

In relation to VAT, it will be necessary to report the relevant transactions with goods as imports or exports. In the area of VAT, the existing procedures applied within the EU related to eg consignment supplies, triangulation, on-line sales of goods, using a single administration point or VAT refunds to persons from other EU member countries might also be affected in relation to Great Britain. Selected financial transactions with Great Britain will newly give rise to a VAT deduction claim.

Further Alternatives

The possibilities of postponing the deadline for Brexit or holding another referendum keep reappearing in the media. However, based on the statements of Theresa May, the British Prime Minister, such scenarios are not to be taken into account. Whether there is any justification for these alternatives will become clear only after the vote about the divorce agreement in the British Parliament.

Our Recommendations

With respect to the uncertain political situation in Britain, we recommend preparing for the possibility of a hard Brexit that does not provide any transition period. Only timely preparation for the possibility of a hard Brexit may eliminate the impacts that a hard withdrawal of Great Britain from the EU will bring.

We will be glad to provide you with a more detailed analysis or assist you in setting up efficient VAT and customs processes.

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A New Draft Act to Prevent the Double Taxation of Transactions with Taiwan

The Czech Republic has not concluded the standard international double tax treaty with Taiwan, as it has with the majority of other countries (as the Czech Republic does not acknowledge the territory of Taiwan as a state, it cannot conclude the contract).

In practice, this may have so far been to the detriment of Taiwan as a business partner as certain types of income generated by Czech firms and individuals coming from Taiwan had to be taxed in the Czech Republic regardless of whether the same transaction has already been taxed in Taiwan, and vice versa. As a result, several years of discussions have been held between the representatives of the two countries and, to prevent double taxation, the draft of a special act has been prepared, unilaterally introducing measures that typically form the content of international treaties. It is expected that Taiwan will introduce similar measures in respect of the Czech Republic.

The draft ensures the objective division of the right to collect income tax between the countries in situations where the source of the income is in one country and the recipient has residence in the other country. In practice, this includes, for example, income generated from construction, assembly and research activities, provision of technical advisory, use of patents, interest, equity investments etc. Furthermore, this also includes, for example, income from dependent activities, income of artists or athletes, and income from the use of copyright.

Based on the proposed legislation, double taxation will be eliminated in the Czech Republic through "simple credit".

In practice, this means that Czech residents generating income in Taiwan will have tax calculated in the Czech Republic from total income reduced by tax paid in Taiwan; however, the maximum amount that may be deducted must be proportional to the Taiwanese partial tax base. Exemption may be applied to personal income from dependent activities performed in Taiwan, with the income exempt from taxation in the Czech Republic if it has already been taxed in Taiwan.

The basic principles of eliminating double taxation are set to be as follows:

- Personal and corporate income will be primarily taxed in the country of the person's tax residence. It will only be taxed in the other jurisdiction under the conditions expressly defined by the provisions of the act.
- Profit from the business activities based in one jurisdiction directly performed in the other jurisdiction through a permanent establishment may be subject to taxation in the other jurisdiction, with the draft act also taking into account "service permanent establishments" (if the activities performed in the territory of the given jurisdiction exceed 9 months in any 12-month period).
- Income from real estate and its use or rental may be taxed in the jurisdiction where the assets are located.
- Profit from the sale of shares or other equity investments whose value is directly or indirectly derived from more than 50% of real estate located in the other territory will be taxed by the source country (the "real estate clause").
- In essence, it will be possible to tax dividends, interest and licence fees in both jurisdictions. If the recipient is a beneficial owner residing in the other country, the tax in the jurisdiction of the income's source must not, under the rules of the given territory, exceed the following thresholds:
  - Dividends – 10% of the gross amount of dividends.
  - Interest – 10% of the gross amount of interest. The rule does not apply to certain types of interest – eg, on loans for the acquisition of goods or equipment, and on loans guaranteed by governmental institutions (these are only taxed in the country of the interest recipient's residence).
  - Licence fees – 5% of the gross amount of licence fees for industrial, commercial or scientific equipment and 10% of the gross amount of other licence fees.

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Effect of a new Czech and Korean double tax treaty from January 2019

Overview

The new version of the double tax treaty between the Czech Republic and the Korean Republic is currently under discussion . The new double tax treaty shall replace the initial version of the treaty dating back to 1992 and substantially changes some areas. The new version provides a wider definition of a permanent establishment and changes the withholding tax rates on interest and dividends.

Service permanent establishment

The amended double tax treaty contains the definition of a service permanent establishment, which arises when services are performed on the territory of another contracting state for a period longer than nine months in any twelve-month period.

Taxation of passive income

Newly, the maximum tax rate of withholding tax on dividends shall be 5 percent for both legal and natural persons. According to existing rules, the dividends may be taxed at a 5 percent tax rate provided the recipient of the dividends holds at least a 25 percent capital share in the company distributing the dividends. The maximum tax rate of withholding tax on interest will be settled at 5 percent.

The withholding tax rate on royalties will stay unchanged, ie 10 percent. Zero percent withholding tax rate applies to any payments received as consideration for the use of, or the right to use, any copyright on literary, artistic or scientific work, including cinematograph films, films or tapes for television or radio broadcasting.

New rules for taxation of Capital Gains

A new paragraph (no. 4) of Article 13 Capital Gains introduces a provision for the taxation of gains derived by a resident of a contracting state from the alienation of shares or comparable interests. If more than 50 percent of their value is derived directly or indirectly from immovable property situated in the other contracting state, the gains may be taxed in that state.

Replacement of articles

Certain articles of the double tax treaty from 1992 were cancelled without replacement, ie Article 14 concerning the taxation of independent personal service or Article 21 concerning the taxation of the income of professors. The corresponding renumbering of articles was performed.

Additional option for elimination of double taxation

Another amendment concerns the elimination of double taxation. According to the new provisions, a Korean company shall be authorised to apply the offsetting method to the tax on dividends withheld by the Czech Republic. This benefit shall be available only if the recipient company holds a share of at least 25 percent in the share capital or voting rights.

New article in the treaty

A new Article 26 Entitlement to Benefits sets the rules for the revocation of benefits provided pursuant to the provisions of the double tax treaty if the relevant transaction was performed without any economic substance and with the only objective to obtain benefits.

Summary

The amended version of the Czech and Korean double tax treaty was concluded on 12 January 2018. The Senate of Parliament of the Czech Republic approved the ratification of the treaty on 17 October 2018. The negotiation about the treaty is on the schedule of the Chamber of Deputies of Parliament of the Czech Republic starting on 4 December 2018.

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News round up

Belgium: cooperative tax compliance program

The Belgian tax authorities are launching a pilot cooperative tax compliance program (CTCP) for "very large enterprises", intended to establish "further collaboration between the tax authorities and the enterprises, based on trust, transparency and faster legal certainty, in order to enhance compliance". Participation in the CTCP will be available only to very large enterprises and must include all members of the group (i.e. resident or non-resident companies and permanent establishments in Belgium, based on consolidation rules). A participating company also will need to comply with a number of other conditions, including timely filing of tax returns; no outstanding tax liabilities; and no significant late payment interest charges, or instances of negligence, violations or fraud in the last three years. The company also must have a functioning tax control framework. The CTCP will cover income tax and taxes associated with income tax, VAT and other miscellaneous taxes as listed in the Belgian tax authorities' announcement. There is no opt-out and the CTCP will always cover all of these taxes.

Germany: draft of Brexit Tax Implementation Act

On 9 October 2018, Germany's Ministry of Finance (MOF) issued a draft law that would introduce tax measures to protect German taxpayers from potential negative consequences of the UK leaving the EU (Brexit Tax Implementation Act). After the UK leaves the EU without a transition period or a withdrawal agreement ("hard Brexit"), the UK will be treated as a country outside of the EU and will no longer be able to benefit from certain German tax measures that are available only to EU-resident taxpayers. To mitigate the most disadvantageous tax consequences resulting from Brexit, the draft law clarifies that Brexit itself will not constitute a "harmful event" for purposes of certain German tax law provisions. If approved, the draft law would become effective on 29 March 2019.

Jersey: new economic substance requirements

On 23 October 2018, Jersey's Minister for External Relations presented draft legislation that would introduce increased substance requirements on certain Jersey resident companies. If approved, the measures would apply as from 1 January 2019 and affect Jersey resident companies with accounting periods commencing on or after that date that undertake "relevant activities." Nine relevant activities would fall within the scope of the proposed rules. These are: banking, financing and leasing, intellectual property holding, fund management, shipping, headquarter activities, insurance and holding company activities and distribution and service centre business.

Netherlands: consultation of implementation of ATAD II

The Dutch government launched a public consultation on 29 October 2018 on potential changes to the corporate income tax act to implement various provisions of the EU Anti-Tax Avoidance Directive (ATAD II), targeting hybrid mismatches in EU and third-country situations. The consultation period will last until 10 December. The ATAD II aims to prevent a (deemed) deduction without inclusion or (deemed) double deduction situations resulting from a hybrid mismatch. The proposed Dutch rules would mainly apply between related parties, basically requiring an ownership interest of at least 25%. A hybrid mismatch may involve a hybrid entity, a hybrid instrument, a hybrid permanent establishment (PE) or a dual resident entity. In addition, a specific provision is proposed for imported hybrid mismatches.

Netherlands: confirmation of CJEU decision in fiscal unity cases by Supreme Court

The Dutch Supreme Court issued a decision on 19 October 2018 confirming the February 2018 decision of the Court of Justice of the European Union (CJEU) on the compatibility of the Dutch fiscal unity regime with EU law. The case had been returned to the Dutch court for a final decision. On 22 February 2018, the CJEU ruled on two joined cases referred by the Dutch Supreme Court. One case involved the anti-profit shifting rules and the other the deduction of currency losses. The CJEU held that the Netherlands cannot apply rules (e.g. anti-profit shifting rules) that generally are applied in both domestic and cross-border situations, but whose effect is more advantageous by entering into a fiscal unity. Since a fiscal unity is available only to Dutch resident companies, the more advantageous treatment is limited to domestic situations. The CJEU concluded that the Netherlands may not deny certain benefits ("elements") of the fiscal unity regime in EU situations simply because EU-resident companies are not allowed to be included in a fiscal unity and, therefore, the anti-profit shifting rules are incompatible with the freedom of establishment principle in the Treaty on the Functioning of the European Union. The CJEU held that the rules relating to currency losses are compatible with EU law. The Supreme Court has now confirmed the CJEU decision, putting an end to the debate on the per element approach.

Spain: draft bill for tax measures

On 23 October 2018, the Spanish government released three draft bills to implement some of the tax measures proposed in the 2019 budget. The bills would introduce new taxes on digital services and financial transactions, as well as measures

to amend the domestic exit tax and controlled foreign company (CFC) rules to transpose the EU Anti-Tax Avoidance Directive (ATAD 1) into domestic law. The bills on the tax on digital services and the tax on financial transactions would enter into force once a three-month period has elapsed from the date the relevant law approved by parliament is published in Spain's official gazette. The measures transposing ATAD 1 are expected to apply to fiscal years starting on or after 1 January 2019.

UK: taxation of digital services

Key measures impacting non-UK owned groups announced in the 29 October 2018 budget include the introduction of a 2% digital services tax as from April 2020, applicable to groups with global revenue from such activities exceeding £500 million a year and income generated in the UK exceeding £25 million. The rules will include safe harbour provisions that reduce the effective rate of tax on businesses with very low profit margins. DST also will be an allowable expense for UK corporate tax purposes and it will not be creditable against corporation tax. The Chancellor made clear that the government would prefer a global tax framework on this matter, but in the interim, this measure will be introduced unilaterally. DST, therefore, is badged as a temporary measure and will cease to apply once a comprehensive global solution is in place.

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Tax liabilities – December 2018

December		
Monday, 10	Consumption tax	Tax maturity for October 2018 (except the consumption tax on alcohol)
Friday, 14	Intrastat	Submission of statements for intrastat for November 2018, paper form
Monday, 17	Road tax	Advance payment on tax for October and November 2018, possibly the maturity of one advance payment of tax (minimally in amount of 70 % of the annual tax obligation) - in a case of taxpayer, who is an operator of trucks, trailers and semitrailers with maximum allowed weight of 12 tonnes and more, to whom the tax is decreased by 48 % according to § 6 paragraph 10 based on Act on Road Tax
	Income tax	Quarter or half-year tax advance payment
Tuesday, 18	Intrastat	Submission of statements for intrastat for November 2018, electronic form
Thursday, 20	Income tax	Monthly payment of deducted advance payments on personal income tax from employment
Thursday, 27	Value added tax	Tax return and tax for November 2018
		EC Sales List for November 2018
		VAT control statement for November 2018
	Energy taxes	Tax return and tax maturity on gas, solid fuels and electricity for November 2018
	Consumption tax	Tax maturity for October 2018 (only the consumption tax on alcohol)
		Tax return for November 2018
		Tax return for claiming of refund of consumption tax, for example on fuel oil, other petrol (benzine) for November 2018 (if applicable)
Monday, 31	Income tax	Payment of special-rate withholding tax for November 2018

Tax liabilities – January 2019

January

Wednesday, 9	Excise tax	Tax maturity for November 2018 (excluding excise tax on alcohol)
Monday, 21	Value added tax	Tax return and tax maturity to MOSS
	Income tax	Monthly deduction of the sum of deducted advance payments for personal income tax from dependent activity
Thursday, 24	Excise tax	Tax maturity for November 2018 (only excise tax on alcohol)
Friday, 25	Gambling tax	Tax return and tax maturity for 4th quarter of 2018
	Value added tax	Tax return and tax for 4th quarter and for December 2018
		Summary report for 4th quarter and for December 2018
		Control report for 4th quarter and for December 2018
	Energy taxes	Tax return and tax maturity on gas, solid fuels and electricity for December 2018
	Excise tax	Tax return for December 2018
	Excise tax	Tax return for claiming of refund of consumption tax for example on fuel oil and other petrol (benzine) for December 2018 (if applicable)
Thursday, 31	Biofuels	Reporting according to Section 19 (8) Act no. 201/2012 Coll.
	Road tax	Tax return and tax for 2018
	Real-estate tax	Tax return (completely) or partial tax return for 2019
	Income tax	Withholding tax payment based on special tax rate for December 2018

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Latest Schedule of OP PIK Calls

The table below presents the latest schedule of the calls already announced under the Enterprise and Innovation for Competitiveness Operational Programme ("OP PIK"), including the deadlines for submitting applications for aid in individual programmes.

Programme name	Programme focus	Type of call	Subsidised territory	Types of recipients*	Planned deadline for submitting aid applications
'Potential' Call V	Subsidy for establishing or developing industrial research, development and innovations centres	Round-based	Czech Republic excluding the capital city of Prague	SME, LE linked to the environment or in cooperation with an SME	From 1 Oct 2018 To 3 Jan 2019
'Applications' Call VI (both with or without effective cooperation)	Subsidy for implementing industrial research and experimental development	Round-based	Czech Republic excluding the capital city of Prague	SME, LE linked to the environment or in cooperation with an SME	From 28 Aug 2018 To 17 Dec 2018
'Real Estate' Call III	Subsidy for modernising production operations and renovating the existing outdated business infrastructure and brownfield sites	Ongoing	Czech Republic excluding the capital city of Prague	SME	From 22 Oct 2018 To 22 May 2019
'Energy Savings in Heat Distribution Systems' Call III	Subsidy for renovating and developing head distribution systems, and increasing the efficiency of cogeneration	Ongoing	Czech Republic excluding the capital city of Prague	SME, LE	From 11 June 2018 To 31 Mar 2019
'Energy Savings' Call IV	Subsidy for activities relating to final energy consumption savings	Ongoing	Czech Republic excluding the capital city of Prague	SME, LE	From 2 July 2018 To 29 Apr 2019
'Renewable Energy Sources' Call IV	Subsidy for projects relating to generation and distribution of renewable energy	Ongoing	Czech Republic excluding the capital city of Prague	SME, LE	From 3 Aug 2018 To 29 Mar 2019
'ICT and Shared Services – Formation and Operation of Shared Service Centres' Call IV	Subsidy for forming and operating shared service centres	Ongoing	Czech Republic excluding the capital city of Prague	SME, LE	From 28 Aug 2018 To 28 May 2019
'ICT and Shared Services – Development and Modernisation of Data Centres' Call IV	Subsidy for modernising and developing data centres	Ongoing	Czech Republic excluding the capital city of Prague	SME, LE	From 31 Aug 2018 To 31 May 2019

** SME – small and medium-sized enterprises, LE – large enterprises*

In early November, the schedule of OP PIK calls was updated, with the 'ICT and Shared Services – New IS/ICT Solutions Design' Call moved to calls to be announced. Based on the latest schedule, four calls are planned to be announced in December:

- 'Innovative Vouchers' Call IV
- 'MARKETING – IVV' Call IV
- 'Technology – Industry 4.0' Call IX
- 'Proof of Concept' Call II

2020: a Crucial Year in Subsidies

The current programming period of the Enterprise and Innovation for Competitiveness Operational Programme ("OP PIK") has been stipulated for the period from 2014 to 2020. Therefore, 2020 will be a landmark year.

A series of as yet successful calls are planned to be announced prior to the end of the programming period.

In early 2019, it will be possible to submit applications for aid under the 'Technologies for Emerging Entrepreneurs' and 'Technologies – Industry 4.0' calls. It will be possible to submit applications for the two calls until May 2019.

Approximately in mid-2019, the 'Innovation' (May 2019) and 'Application' (July 2019) calls are planned to be opened. The calls are additionally planned to be announced in Q1/2020. As part of the planned 'Innovation' calls, projects focusing on the issue of drought are considered to be favoured.

A series of measures are planned to be adopted before the end of the current 2014–2020 programming period. These primarily include the new activity "Acquisition of Digital Technical Maps and Formation of a Coal Platform". It will cover the coal-mining regions – the Moravian-Silesian, Ústí nad Labem and Karlovy Vary Regions – which will be able to receive a greater portion of funds through subsidies.

The upcoming 2021–2027 programming period will primarily support activities relating to low-carbon economy, industrial energy savings and renewable sources of energy, Industry 4.0, digital and smart economy, and effective use of resources as part of circular economy. Financial tools such as loans, guarantees, equity investments and others will constitute a significant feature of aid in the new, post-2021 programming period.

European Commission Approves an Investment Package of EUR 243 Million from the EU's Budget for LIFE Projects

On Thursday, 25 October, the European Commission approved an investment package of EUR 243 million from the EU's budget to fund projects under the LIFE Programme.

The programme supports projects focusing on the conservation of nature and the landscape, the environment, and climate across the whole European Union. The project's objective is to promote the development of low-emission economy and contribute to the conservation of the environment and biodiversity. The programme started in 1992 and has since supported over 4,600 projects in the European Union and third countries.

Of the total EUR 243 million, EUR 196.2 million will be allocated to supporting projects related to the environment and efficient use of resources, nature and biodiversity, environmental management and raising awareness of the environment. The remaining EUR 46.8 million is earmarked for projects focusing on the mitigation of climate change, adaptation to it or climate management.

Based on the sub-programme, corporate entities, public entities, universities, scientific research institutions and others will be eligible to apply for aid.

Planned Announcement of Call No. 97 under the 'Employment' Operational Programme

The call is set to be announced by the Ministry of Labour and Social Affairs of the Czech Republic. Call No. 97 is included in the "Support of Employment and Workforce Adaptability" priority axis, which focuses on supporting employee professional training with emphasis on technical and key competencies that may relate to IT, languages, soft skills or technical skills.

Employee training is eligible for aid of CZK 500,000 – CZK 10,000,000. Newly-formed firms may apply for a maximal amount of CZK 2,000,000.

The call is planned to be announced in March 2019, with the deadline for submitting applications for aid set to expire in May 2019.

Changes to OP PIK Project Administration

The Ministry of Industry and Trade has issued a new document – Categorisation of Types of Changes to Projects – which came into force on 30 October 2019. The newly promulgated document informs subsidy applicants and recipients about individual types of changes to projects and about which of them are permitted and which are not. Furthermore, the document provides information about the necessary change-related administration and deadlines for making changes or, to be precise, filing an application for a change.

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If these issues relate to your company, we would be happy to provide you with more detailed information.
Feel free to contact us at any time

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Restructuring Reserve

Restructuring refers to a programme that significantly changes an entity's subject of business or the way it operates. If the entity enters the restructuring process, it should create a restructuring reserve in line with applicable legislation as of the effective date of the restructuring. This article will provide you with more details about when the restructuring reserve should be accounted for, what items it should involve, including the specification of the respective legal regulation.

The restructuring process may include in particular the relocation of business activities to another region, the closing down of operation as well as reduction or discontinuation of business activities.

Restructuring reserves in Czech legislation

The legal regulation of restructuring reserves is based on the general provisions of accounting for reserves as defined in Act No. 563/1991 Coll., on Accounting, as amended (hereinafter the "Act"). Section 25 (3) of the Act stipulates that entities shall consider, as of the balance sheet date, all foreseeable risks and potential losses relating to assets and liabilities which are known to them as of the date of preparing the financial statements regardless of whether the entity recorded operating profit or loss. In addition to provisions and depreciation of assets, reserves are also defined in this Section. Pursuant to Section 26 (3) of the Act, reserves are intended to cover liabilities and expenditure the nature of which is clearly defined and which are either likely to be incurred or certain to be incurred as of the balance sheet date but uncertain as to their amount or as to the date on which they will arise.

Basic principles of creating and using reserves are stipulated in Accounting Standard No. 004 Reserves with a reference to Regulation No. 500/2002 Coll. (hereinafter the "Regulation") implementing certain provisions of the Accounting Act.

Reserves are addressed in greater detail by International Financial Reporting Standards, specifically IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, from which certain rules that are applicable in the Czech accounting environment and included in this article may be deducted.

Content definition of the restructuring reserve

Item B.4 'Other Reserves' primarily includes a restructuring reserve that may only be created and used in respect of expenditure necessary for realising the restructuring programme which, however, do not relate to the entity's ongoing activities, the nature of which is clearly defined and which are likely to be incurred but uncertain as to their amount or as to the date on which they will arise.

The definition of the restructuring reserve is *de facto* contained in a single provision – Section 16 (4) of the Regulation with effect from 1 January 2016 when a more-detailed definition of restructuring reserves was removed from Czech Accounting Standard No. 004 Reserves.

The provision which is no longer part of the current Regulation but is still used in accounting practice also included a list of expenditure ruled out from the accounting reserve; this specifically relates to the retraining or relocation costs of employees who will remain to be employed at the entity or marketing costs.

The restructuring reserve must include solely expenses which have been, or will be, incurred in the restructuring process and as such would not be incurred without the restructuring being performed.

As an example, expenses to be included in the restructuring reserve include the costs of advisory services, legal and tax advisory necessary for the restructuring process to be realised in line with legal regulations, costs of crisis management ensuring that the restructuring process is governed in accordance with the set schedule, costs of disassembly of the existing production equipment, fines and penalties for premature termination of contracts with sub-suppliers and customers, severance pay to dismissed employees etc.

On the other hand, the restructuring reserve must not include the costs of project work and advisory services concerning the entity's future operation model or relocation, investments in distribution networks and systems to ensure the future subject of the entity's activities, bonuses and remuneration to employees who will remain to be employed at the entity, and employee requalification costs as these costs relate to the entity's "ongoing activities" and must be recognised in the accounting records in the period in which they were incurred.

Restructuring may also involve additional steps that, by their nature, arise from the restructuring process, being rather uncustomary, such as additional provisions against fixed assets and inventory due to a decline in a certain segment and the resulting "forced" sale, disposal of assets and inventory or physical liquidation (scrapping) etc.

Furthermore, we would like to draw attention to the term reorganisation as a regime within insolvency proceedings. Reorganisation may, but does not have to, have similar implications as restructuring.

Timing of the recognition of the restructuring reserve

The restructuring reserve is created by an entity based on the restructuring programme approved by a relevant body pursuant to a specific legal regulation, or by shareholders in a business corporation. The restructuring programme shall constitute a formal plan of changes in the entity, defining areas and employee positions to be affected by the restructuring and the budget, i.e. calculation of anticipated expenses to be incurred in relation to the restructuring process. The affected parties must be notified of the restructuring programme and all steps on the part of the entity must be aimed at the fulfilment of the plan

to generate real expectations about realisation.

Creation and use of the restructuring reserve

Restructuring reserves are created and used in line with Sections 27 and 57 of the Regulation and Art. 4.2. Of Accounting Standard No. 004 Reserves.

The creation of reserves is recognised in the relevant account within account group 45 – Reserves by a corresponding entry in the relevant expense account within account group 55 – Depreciation, reserves, comprehensive deferred expenses and operating provisions. The use of reserves or their reversal due to redundancy is recognised in the relevant account within account group 45 – Reserves by a corresponding entry in the relevant expense account within account group 55 – Depreciation, reserves, comprehensive deferred expenses and operating provisions.

The creation and use of reserves is disclosed by the entity in its notes to the financial statements. Similarly to other reserves, the restructuring reserve is subject to reconciliation in which the amount and appropriateness of the reserve is assessed, or the budget for the restructuring programme costs is updated for the reserve to be the best estimate of expenditure which are likely to be incurred, or, in the event of payables, an amount necessary for settlement. For the sake of clear arrangement, the reserve is recommended to be maintained in a stand-alone analytical account.

Tax aspects of accounting for restructuring reserves

The restructuring reserve is not a tax-deductible expense. For corporate tax calculation purposes, the tax base must be increased by the amount of the restructuring reserve. Expenses become tax-deductible when they are actually incurred in relation to the restructuring process – i.e. in the period in which they incur. On those grounds, a temporary tax difference, i.e. A deferred tax asset, arises in respect of the restructuring reserve in the calculation of a deferred tax, similarly as in the accounting for other tax non-deductible reserves.

Furthermore, we would like to note that a reserve for various items related to employee remuneration in restructuring may not necessarily include its current component of social security and health insurance, such as when severance pay is concerned. For this reason, we consider it necessary to pay attention to individual items of which the reserve is composed.

Creation and use of reserve as a non-cash transaction

I addition, we would also like to emphasise that although the creation and use of a restructuring reserve affects the entity's profit or loss, it does not have a direct influence on an increase or decrease in financial resources. The line 'Change in provisions and reserves' in the statement of cash flows, part Cash flows from ordinary activities (operating activities), prepared using the indirect method must be adjusted by the amount corresponding to the creation and use of the reserve.

Approach to the presentation in the financial statements

The balance, creation and use of reserves have their required positions in the balance sheet, or the profit and loss account. If the restructuring in the reporting period in which the restructuring reserve is recognised for the first time has implications to other areas (such as depreciation or recognition of provisions for fixed assets or inventory), it is appropriate to disclose relevant information on the effect of the restructuring in the notes to the financial statements in a comprehensive and cohesive manner, including a summary of implications for other areas concerned. Furthermore, restructuring will, by its nature, be usually an extraordinary activity, i.e. The costs of restructuring (and also revenues, if any) will typically be presented as extraordinary – in the operating or financial areas, according to their nature.

Conclusion

The restructuring process entails uncertainty and significant expenses, substantially affecting the entity's operation. In creating the restructuring reserve, the prudence concept as one of the basic accounting principles needs to be taken into account. Simultaneously, the calculation of the amount of the reserve shall only include expenses which are necessary for realising the restructuring and do not relate to the entity's ongoing activities.

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Invitation to a Seminar

News in Czech Accounting

Prague, Pilsen and Hradec Kralove

We would like to invite you to Deloitte's traditional autumn seminar focusing on the possible obstacles in preparing financial statements. The seminar will comprise practical examples and tips in the areas where, as advisors and auditors, we come across the most findings. Furthermore, we will discuss the changes to the Czech Accounting Legislation effective as of 1 January 2018. The programme will also include new tax developments and their impact on companies' financial statements.

The seminar is predominantly intended for accountants, economists and financial managers preparing or involved in the preparation of financial statements under Czech accounting legislation and the related tax and legal regulations, and for all of you who want to learn more about Czech accounting and the most recent tax and legal developments.

The seminar is not intended for the employees of companies engaged in accounting advisory.

Seminars will be held in Czech in December in Prague, Pilsen and Hradec Kralove and will be delivered by our professionals.

Dates

Prague:	11 December 2018
Pilsen:	5 December 2017
Hradec Kralove:	13 December 2018

More information on:
www.akce.deloitte.cz

IASB issued amendments to IFRS 3 regarding the definition of a business

On 22 October 2018, the IASB issued 'Definition of a Business (Amendments to IFRS 3)' aimed at resolving the difficulties that arise when an entity determines whether it has acquired a business or a group of assets. The amendments are effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020.

Background

The post-implementation review of IFRS 3 *Business Combinations* revealed that entities have difficulties when determining whether they have acquired a business or a group of assets. As the accounting requirements for goodwill, acquisition costs and deferred tax differ on the acquisition of a business and on the acquisition of a group of assets, the IASB decided to issue narrow scope amendments aimed at resolving the difficulties that arise when an entity is determining whether it has acquired a business or a group of assets.

Changes

The amendments in *Definition of a Business* (Amendments to IFRS 3) are changes to Appendix a Defined terms, the application guidance, and the illustrative examples of IFRS 3 only.

Minimum requirements to meet the definition of a business

The amendments clarify that while businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business. However, to meet the definition of a business, an integrated set of activities and assets must include, as a minimum, an input and a substantive process that together significantly contribute to the ability to create output. The IASB also clarifies that outputs in and of themselves are not sufficient to determine that an integrated set of activities and assets is a business. Instead, the entity needs to demonstrate that both an input and a substantive process have been acquired.

To clarify that a business can exist without including all of the inputs and processes needed to create outputs, the IASB replaced the term 'ability to create outputs' with 'ability to contribute to the creation of outputs'.

Assessing whether an acquired process is substantive

To determine whether an acquired process is substantive, different criteria apply, depending on whether there are outputs at the acquisition date. New guidance and illustrative examples are added to help entities assess whether a substantive process has been acquired.

Market participant's ability to replace missing elements

Before the amendments, IFRS 3 stated that a business did not need to include all of the inputs or processes that the seller used in operating the business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.

The IASB has now removed this reference and instead, as described above, decided to focus on whether acquired inputs and acquired substantive processes together significantly contribute to the ability to create outputs.

Narrowed definition of outputs

To narrow the definition of outputs, the IASB has amended the definition of a business in Appendix A of IFRS 3 as well as the definition of outputs in the Application Guidance to IFRS 3. These amendments put the focus of outputs on goods and services provided to customers. By that, the IASB wants to achieve consistency with the notion of outputs in IFRS 15 *Revenue from Contracts with Customers.*

The amendments remove from the new definitions references to returns in the form of lower costs and other economic benefits provided directly to investors or other owners, members or participants. In the IASB's view, the reduction of costs is not a helpful concept to distinguish between acquisitions of a business and asset acquisitions. Many asset acquisitions that do not include a substantive process may also be made with the motive of lowering costs.

Optional test to identify concentration of fair value

The IASB has introduced an optional test that provides a simplified assessment of whether an acquired set of activities and assets is not a business (the concentration test). If the concentration test is met, the set of activities and assets is determined not to be a business and no further assessment is needed. If the test is not met, an entity performs the assessment set out above to determine whether or not the acquired set of activities and assets is a business.

An example of how the test is performed is added to the Illustrative Examples that accompany IFRS 3.

Interaction with the FASB

IFRS 3 and the corresponding US GAAP requirements (SFAS 141(R)) are substantially converged. With regard to the definition of a business, the PIR of SFAS 141(R) revealed similar issues as the PIR of IFRS 3. Consequently, in 2017 the US Financial Accounting Standards Board (FASB) amended US GAAP.

Although the IASB's amendments to IFRS 3 are based on similar conclusions as the US GAAP amendments, they differ in some respects. However, the IASB expects that the amendments will lead to more consistency in applying the definition of a business across entities applying IFRS and entities applying US GAAP.

Effective date and transition requirements

The amendments are effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period. Earlier application is permitted.

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IASB issued amendments to IAS 1 and IAS 8 regarding the definition of materiality

On 31 October, the International Accounting Standards Board (IASB) issued 'Definition of Material (Amendments to IAS 1 and IAS 8)' to clarify the definition of 'material' to make it easier for companies to make materiality judgements.

Background

The materiality project arose as part of the IASB's Disclosure initiative started in 2012. A draft practice statement on materiality was published on 28 October 2015, however, subsequently it became clear that some of the proposed guidance needed to be authoritative to have the desired effect, so the project was split up into a part that would see a practice statement published and a part that was intended to result in amendments to IAS 1 and IAS 8. The finalised Practice Statement *Making Materiality Judgements* was published in September 2017 at the same time as an exposure draft ED/2017/6 *Definition of Material (Proposed amendments to IAS 1 and IAS 8*), which is being finalised now.

Changes and reasoning behind the changes

The definition of material, an important accounting concept in IFRS Standards, helps companies decide whether information should be included in their financial statements. The updated definition amends IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

The amendments are a response to findings that some companies experienced difficulties using the old definition when judging whether information was material for inclusion in the financial statements.

- Old definition of 'material': *Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements* (IAS 1 *Presentation of Financial Statements*).
- New definition of 'material': *Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.*

Three new aspects of the new definition should especially be noted:

- Obscuring. The existing definition only focused on omitting or misstating information, however, the Board concluded that obscuring material information with information that can be omitted can have a similar effect. Although the term obscuring is new in the definition, it was already part of IAS 1 (IAS 1.30A).
- Could reasonably be expected to influence. The existing definition referred to 'could influence' which the Board felt might be understood as requiring too much information as almost anything 'could' influence the decisions of some users even if the possibility is remote.
- Primary users. The existing definition referred only to 'users' which again the Board feared might be understood too broadly as requiring to consider all possible users of financial statements when deciding what information to disclose.

During redeliberations, the Board spent a lot of time on discussing what constitutes obscuring information. The amendments stress especially five ways material information can be obscured:

- if the language regarding a material item, transaction or other event is vague or unclear;
- if information regarding a material item, transaction or other event is scattered in different places in the financial statements;
- if dissimilar items, transactions or other events are inappropriately aggregated;
- if similar items, transactions or other events are inappropriately disaggregated; and
- if material information is hidden by immaterial information to the extent that it becomes unclear what information is material.

The new definition of material and the accompanying explanatory paragraphs are contained in IAS 1 *Presentation of Financial Statements*. The definition of material in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* has been replaced with a reference to IAS 1.

Effective date

The amendments are effective for annual reporting periods beginning on or after **1 January 2020**. Earlier application is permitted.

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IFRIC 23 endorsed for use in the EU

On 23 October 2018, IFRIC 23 *Uncertainty over Income Tax Treatments* was endorsed by the European Commission for use in the European Union. The EU effective date is the same as the IASB's effective date (annual periods beginning on or after 1 January 2019). Earlier adoption of IFRIC 23 is permitted.

IFRIC 23 was issued in June 2017. We informed you in detail about the new standard in the Accounting News in July 2017.

In today's article, we will summarise key changes arising from IFRIC 23.

Background

A question has arisen in practice as to how uncertainty about the acceptability by a tax authority of a particular tax treatment used by an entity in its income tax filings ('uncertain tax treatment') should be reflected in the financial statements. As a consequence, the Interpretations Committee decided to develop an interpretation.

Scope

The interpretation is to be applied to the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates, when there is uncertainty over income tax treatments under IAS 12 *Income Taxes*.

Issues and consensus

Whether tax treatments should be considered collectively

An entity is required to use judgement to determine whether each tax treatment should be considered independently or whether some tax treatments should be considered together. The decision should be based on which approach provides better predictions of the resolution of the uncertainty.

Assumptions for taxation authorities' examinations

An entity is to assume that a taxation authority with the right to examine any amounts reported to it will examine those amounts and will have full knowledge of all relevant information when doing so.

Determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates

An entity has to consider whether it is probable that the relevant authority will accept each tax treatment, or group of tax treatments, that it used or plans to use in its income tax filing.

- If the entity concludes that **it is probable** that a particular tax treatment is accepted, the entity has to determine taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment included in its income tax filings.
- If the entity concludes that **it is not probable** that a particular tax treatment is accepted, the entity has to use the most likely amount or the expected value of the tax treatment when determining taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates. The decision should be based on which method provides better predictions of the resolution of the uncertainty.

Effect of changes in facts and circumstances

An entity has to reassess its judgements and estimates if facts and circumstances change.

Disclosures

The interpretation does not contain any new disclosure requirements. Instead it highlights existing disclosure requirements in IAS 1 and IAS 12.

Effective date and transition

An entity applies IFRIC 23 for annual reporting periods beginning on or after **1 January 2019**. Earlier application is permitted.

Entities can apply the Interpretation using either of the following approaches:

- **Full retrospective approach**: this approach can be used only if it is possible without the use of hindsight. The application of the new Interpretation will be accounted for in accordance with IAS 8, which means comparative information will have to be restated; or
- **Modified retrospective approach**: no restatement of comparative information is required or permitted under this approach. The cumulative effect of initially applying the Interpretation will be recognised in opening equity at the date of initial application, being the beginning of the annual reporting period in which an entity first applies the Interpretation.

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IFRS EU Endorsement Process

The European Financial Reporting Advisory Group (EFRAG) updated its report showing the status of endorsement of each IFRS, including standards, interpretations, and amendments, most recently on 2 November 2018.

As of 28 November 2018, the following IASB pronouncements are awaiting European Commission endorsement for use in the EU:

Standards

- IFRS 14 *Regulatory Deferral Accounts* (issued in January 2014) - the European Commission has decided not to launch the endorsement process of this interim standard and to wait for the final standard
- IFRS 17 *Insurance contracts* (issued in May 2017)

Amendments

- Amendments to IFRS 3 *Definition of a Business* (issued in October 2018)
- Amendments to IFRS 10 and IAS 28 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (issued in September 2014)
- Amendments to IAS 1 and IAS 8 *Definition of Material* (issued in October 2018)
- Amendments to IAS 19 *Plan Amendment, Curtailment or Settlement* (issued in February 2018)
- Amendments to IAS 28 *Long-term Interests in Associates and Joint Ventures* (issued in October 2017)
- *Annual Improvements to IFRS Standards 2015–2017 Cycle* (issued in December 2017)
- *Amendments to References to the Conceptual Framework in IFRS Standards* (issued in March 2018)

Click here for the Endorsement Status Report

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Invitation to Autumn Seminar

IFRS News 2018

Webcast took place on 16 October 2018.
Its record is available here.

Most Frequent Errors in Financial Statements Prepared under IFRS

We would like to invite you to Deloitte's autumn seminar on International Financial Reporting Standards (IFRS), this time dedicated to the errors that we most frequently encounter in auditing the annual accounts of our clients and that often recur in the financial statements. We will also focus on missing disclosures in the notes.

In addition, we will provide you with an overview of the standards and interpretations effective for reporting periods starting on or after 1 January 2018. We will address how the implementation of the new standards IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* should be reflected in the financial statements for the year ended 31 December 2018.

We will also present the possible approaches to the transition to IFRS 16 *Leases*, which will become effective on 1 January 2019.

We will be happy to answer any of your questions, for which there will be sufficient time.

The seminar is predominantly intended for accountants, economists and financial managers of projects relating to IFRS and for all who want to know more about IFRS.

The seminar will be held in Prague in the Czech language and will be delivered by our professionals.

Date

- Prague: 17 December 2018 NEW DATE!

More information is available at:
www.akce.deloitte.cz

US GAAP

Cyber threat considerations related to implementation of internal accounting controls

In response to the continued increase in cybercrime, the United States Securities and Exchange Commission (SEC) issued an investigative report on 16 October 2018 that cautioned companies to consider cyber threats when they are implementing their internal accounting controls.

The report focuses on the internal accounting controls of nine issuers in a range of sectors "that were victims of one of two variants of schemes involving spoofed or compromised electronic communications from persons purporting to be company executives or vendors," commonly referred to as business e-mail compromise (BEC) scams. According to the SEC's report each of the nine issuers lost at least $1 million; two lost more than $30 million. In total, the nine issuers lost nearly $100 million to the perpetrators, almost all of which was never recovered.

What Is a BEC Scam?

As described in the SEC's report, a BEC scam occurs when attackers use compromised or fraudulent e-mail addresses to target specific employees within organizations and ask them to participate in what appear to be legitimate transactions or to make changes to key payment or vendor information.

The scam typically involves the hacking of an individual's e-mail account, which is then used to send e-mails to other individuals within an organization or outside of it (e.g., to customers). This occurs more commonly in hosted e-mail solutions that are not protected by multifactor authentication (MFA). It also occurs in scenarios in which hackers are able to set up rules for e-mail forwarding and deleting to monitor and remove communications that may be used to detect the unauthorized use of the e-mail address. Fraudulent or spoofed e-mails commonly look similar to or have domain names that are similar to legitimate correspondence.

The SEC's Check of Internal Accounting Controls

The SEC considered whether the companies affected by the BECs complied with the requirements of Sections 13(b)(2)(B)(i) and (iii) of the Securities Exchange Act of 1934, under which certain issuers are required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are executed with, or that access to company assets is permitted only with, management's general or specific authorization." Further, the report emphasized that "while the cyber-related threats posed to issuers' assets are relatively new, the expectation that issuers will have sufficient internal accounting controls and that those controls will be reviewed and updated as circumstances warrant is not."

The full version of the SEC's Report on investigation is available here.

You can find more information about BEC Scams in Heads Up (Volume 25, Issue 18) issued by Deloitte on 30 October 2018. The following topics are covered in the article in detail:

- How does a BEC Scam occur?
- How Can BEC Scams Be Identified and Avoided?
- What Controls May Help Companies Prevent or Detect These Types of Cybercrimes?
- SEC's Focus on Cybersecurity

The cybersecurity landscape continues to evolve, and schemes like the ones described in the SEC's report are increasing as more economic activities take place through digital technology and electronic communications. The BEC examples described above underscore the importance of devising and maintaining a system of internal accounting controls to address this kind of cyber-related fraud. Training and user security awareness play critical roles in both the implementation and operating effectiveness of controls.

Sources:

Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements

Heads Up — Cyber threat considerations related to implementation of internal accounting controls

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Transparent Company Sale

The past few years were nearly the "Golden Age" for company owners contemplating the sale of their businesses. The economy as well as enterprises have experienced a boom; interest rates continue to be low, with the indication of their increase in the near future motivating investors even more strongly to purchase shares in prosperous companies right now. As a result, potential investors are throwing money at such businesses.

Strong competition among investors interested in buying a company creates pressure not only on financial and other parameters of their bids but also on the promptness of the execution and settlement of the entire transaction. Some investors are thus willing to accept a much higher degree of risk, for example by curtailing and narrowing, or even eliminating, the due diligence process of the company of interest to accelerate the transaction as a whole. This may, yet often seemingly, pose an advantage for sellers. The investor's insufficient review of the subject of purchase prior to the transaction often becomes the source of future disputes between the original company owner and the new investor.

Even the basic legal framework of the most common purchase agreement requires that the seller bring to the purchaser's attention any defects on the subject of the purchase. In the area of mergers and acquisitions, this obligation has had a much broader interpretation for decades due to the established institute of the seller's assurance concerning the capital investment to be sold itself (i.e. equity interests and shares) as well as all possible aspects of operation of the company in question. The seller can only be released from the liability for certain defects when compared to the company's condition as asserted in the sale if they notified the purchaser of or allowed the purchaser to identify those defects, such as by providing the most detailed supporting documentation for performing the vendor's due diligence.

A risky course of action on the investor's part in acquiring an enterprise without customary due diligence may, as a consequence, turn against the original owner that has not been given the opportunity to inform the investor on potential defects. Resulting disputes impose a significant financial burden on both parties involved, which could, however, be avoided. Nevertheless, the seller may assume a more-active role in the transaction and perform the vendor's due diligence for the purchaser. The seller may also have the company's as-is state assessed by relevant specialists and handle the resulting findings, which may cause harm to the purchaser, transparently within transaction-related negotiations to clearly distribute related risks among the parties to the transaction. Each investor may address transaction risks by reducing the purchase price; nevertheless, this will only provide the seller with a bid that is truly comparable. By accepting it, the seller will have a substantially higher level of certainty that it will retain the transaction proceeds in the future which is among the key factors in company sales.

(This article was published as a commentary in the Leaders Voice column, the Hospodářské noviny daily on 29 October 2018)

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Understand First and Then Regulate

Legal regulations may sometimes be scary. They a *priori* provoke aversion, generating enormous compliance costs. Rules are often duplicate or even contradictory. Public regulation is beyond control in certain areas, with the available capacity of companies or the current technology being unable to ensure full compliance with all norms. Regulations are often inadequate to the risks against which they should protect, disregarding those of greater significance.

We have extensive experience with all of this. The British "Locomotive Act" dated 1861 required "locomotives" (mechanically propelled vehicles) to be operated by two persons and not to exceed the speed limit of 10 mph. More-stringent criteria were introduced by the Red Flag Act in 1865, requiring a third person to carry a red flag at least 60 yards ahead of an approaching vehicle as a warning (the act also reduced the maximum speed to 4 mph). The Act was abolished three years later.

A great many similar episodes can be found in the history of regulations. Does it mean that the new business was not supposed be regulated by the state at that time? Regulation was certainly necessary but the state should have better understood the coming technology. This error is frequently repeated at the present time, with the difference that the emergence of new technologies has accelerated at an unprecedented pace, resulting in a growing gap between the need for regulation and its existing state.

Traditional regulation is becoming outdated and public administration – we all – are on the verge of regulatory revolution. We must collaborate to find new, faster and safer forms of business regulation that will not hinder innovations, effectively regulating new risks while internalising new externalities.

First, it is necessary to revise the current regulations – by means of tools, fortunately. Deloitte conducted a data and text analysis of the 2017 US Code of Federal Regulations, having identified 18,000 Sections of 217,000 with a similar wording. Such "exercises" enable an effective elimination of duplicates and conflicts in the rule of law that may be further clarified by parallel transitions to regulatory templates, as attempted by the Czech Chamber of Commerce in respect of the Legal electronic system.

Nevertheless, a sole revision of the existing regulations will be insufficient. We need to start employing tools of adaptive regulations with the use of new technology as well as psychological and sociological insight, predictive analytics and crowdsourcing to identify presumable violation of legislation and to understand the need for regulatory changes, and chatbots to explain statutory duties to users for the limited capacity of officials to be saved for more demanding activities. It is necessary to involve regulatory experience more quickly. We need to use regulatory labs and incubators to test new products, services and business models in a regulated environment without complying with all of the existing regulation or with the use of new one.

We need innovations, which pose an increased burden on officials, to be used for ensuring more-efficient public administration. Regulators can work more effectively while promoting innovations and protecting constitutional rights and freedoms.

I am looking forward to the debate next year stirred up by the 10th annual Act of the Year survey as well as to the regulatory revolution we are entering just now.

(This article was published as a commentary in the Leaders Voice column, the Hospodářské noviny daily on 5 November 2018)

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