

International Fiscal Association

2018  
Seoul Congress

cahiers

de droit fiscal  
international

VOLUME 103

**A: Anti-avoidance  
measures of general  
nature and scope  
– GAAR and  
other rules**



1938-2018

### Summary and conclusions

The legal system in the Czech Republic had been influenced by Marx-Leninist principles and socialist ideology until 1989. With the fall of the iron curtain in November 1989, the system started to take on its current form.

The Czech legal system does not include a definition of tax avoidance, tax planning, abusive tax planning or aggressive tax planning. No clear distinction between these terms exists and the use of the terms is often confused. Tax evasion, however, is a criminal act described in the Criminal Code.

Since the very beginning of the system in 1990, Czech tax law has included both general anti-avoidance rules (“GAARs”) and special anti-avoidance rules (“SAARs”). Regarding GAARs, only the substance-over-form rule (i.e. the principle of material truth) and reduction of tax liability in another way are explicitly included in the tax law. SAARs include especially transfer pricing rules, thin capitalisation rules, rules applicable to certain reorganisations, and provisions on tax securement and withholding tax applicable to payments made to tax havens.

The abuse of tax law is a judge-made doctrine. It penetrated the tax law in the Czech Republic in November 2005 based solely on legal theory and case law. Previously, the abuse of law was known only in civil law. The Czech courts are significantly influenced by the Court of Justice of the European Union (“ECJ”) case law regarding the abuse of law and follow its tests in principle.

Firstly, the courts test the intent or purpose of the transaction, i.e. whether it has been realised with the main purpose of obtaining a tax benefit. The Czech Supreme Administrative Court (“SAC”) defines the main purpose as a purpose that is incomparably more important than potential other purposes and that overshadows and marginalises the other purposes in substance, so that the other purposes can be ignored when analysing the economic sense of the transaction.

Secondly, the courts test to ascertain that the result is not contrary to the sense and purpose of the tax legislation. The objective result is important, i.e. the real outcome of the transaction rather than the subjective intentions of the taxpayers.

In addition to the ECJ, Czech case law requires the existence of unjustified harm, meaning that the offending taxpayer reduces the tax income of a state, which could otherwise be redistributed for the benefit of other members of society. The test seems redundant, since any decrease in tax results in less distributable income. The test seems inspired by a similar explicit regulation in civil law valid in 2005 when the courts, influenced

<sup>1</sup> Tax Advisor, Expert Witness and Group CFO in an international company.

<sup>2</sup> Tax Advisor and Partner in international professional services network.

<sup>3</sup> The reporters are grateful for the extensive support and valuable comments from JUDr. Barbara Porizkova, judge on the Supreme Administrative Court of the Czech Republic.

by the ECJ, decided to extend the civil law doctrine to tax law.

The courts consistently rule that the abuse of law should only be used in exceptional cases as an “emergency brake”. They consider the abuse of law, in a sense, “ultima ratio”. For this reason, it must be applied as restrictively as possible and in careful comparison with other similarly important principles embedded in the legal order, especially with the principle of legal certainty with which it – quite logically – competes the most.

GAARs and the abuse of law are topical issues, which is evident from the number of judgements chosen as examples by the reporters. GAARs have recently been included in many tax treaties. The Czech Income Taxes Act implemented the anti-avoidance measures of the amended parent-subsidiary directive.

The number of court cases on the abuse of law registered by the Supreme Administrative Court (“SAC”) has increased dramatically, from no cases registered prior to 2004 to 42 registered between 2004 and 2010, and to over 200 (!) registered in the period from 2011 to now. The majority of them pertain to value added tax (“VAT”), direct taxes, and tax administration. Sometimes, the SAC approved the use of the abuse-of-law doctrine, other times the SAC denied it.

The trend contradicts the court's statements that the abuse of law should only be used exceptionally as “ultima ratio”. It rather suggests that the tax authorities started using this court-invented doctrine extensively as a general anti-avoidance rule for all situations they did not like. This may indicate their resignation or inability to thoroughly analyse the tax cases in order to apply the rules and principles explicitly embedded in the tax law or to keep the tax legislation clear and up-to-date.

The tax legislation does not seem to be changing anytime soon. The Ministry of Finance does not see a benefit to introducing the GAARs suggested by article 7 ATAD. The Ministry believes that the provisions of the Czech legislation and case law cover this issue sufficiently. No introduction of new or revision of the existing GAARs is expected soon.

It seems that the state is shifting its responsibilities for making the tax environment predictable by preparing clear and robust tax legislation for the courts. This is at the cost of taxpayers' reliance on basic principles such as the principle of legal certainty, legality, predictability of law, “in dubio pro libertate” and other basic principles concurring with the abuse-of-law doctrine. There is no legal certainty on where the boundary lies between the right of the taxpayer to arrange his tax matters in the most advantageous manner and unlawful tax avoidance.

## I Introduction

This branch report aims to provide the reader with general and specific anti-avoidance rules that occur and have been applied in the Czech Republic and describes recently adopted instruments inspired by the OECD's BEPS project.

First, the reporters want to mention that the existing Czech legal system has its origin in 1990. The Czech legal system had been influenced by Marx-Leninist principles and by socialist ideology until 1989. After the fall of the iron curtain in November 1989, it was necessary, with regard to changes in social, political and economic conditions, to implement new acts, such as an income tax act, VAT act and tax code, or to revise existing acts. Many changes occurred during this time, the most significant included changes connected with the country's EU-entry in 2004 and civil-law recodification in 2014.

The legal system in the Czech Republic does not include a legal definition of tax avoidance, tax planning, abusive tax planning or aggressive tax planning. No clear distinction between these terms exists and the use of the terms is often confused. However, tax evasion is a criminal act described in the Criminal Code<sup>4</sup> in article 240 (1) and in article 241 (1).

## II General Anti-Avoidance Rules in the Czech Republic

In this chapter, the reporters summarise the historical background, legal principles, case law, treaty provisions and practical experience with respect to GAARs in the Czech Republic. This chapter starts with general principles of law and goes into the details of specific principles used in tax law.

### II.1 Constitutional background

In a tax law, there is a conflict of interest between the state's levying of taxes and the interest of taxpayers to minimise their taxes in line with statutory rules and orders. The Declaration of basic rights of the Czech Republic stipulates the main principles for how to handle this conflict. The Constitution of the Czech Republic describes the link between the domestic law and provisions in international treaties.

#### II.1.1 *The Declaration of basic rights*

The Declaration of basic rights<sup>5</sup> with regard to tax law stipulates in:

- Article 2 (2): *“The state power can be exercised only in cases and in limits stipulated by the law and in a way stipulated by the law.”*
- Article 2 (3): *“Everyone can do what is not forbidden by the law and no one is allowed to be obliged to do what the law does not impose.”* What is not forbidden is allowed.
- Article 11 (5): *“Taxes and charges can be imposed only under the rule of law.”*

This means the state should be interested in levying taxes in the right amounts, not in as high amounts as possible. This statement was approved by the Constitutional Court in its finding no. IV. US 666/02 of 15 December 2003.<sup>6</sup> The taxpayers are obliged to pay taxes pursuant to the law and can use the best solution offered by the law for minimising their tax assessment. The SAC mentioned this, among other things, in its judgement no. 2 Afs 178/2005 – 64 of 23 August 2006.<sup>7</sup>

<sup>4</sup> Act no. 40/2009, Coll.

<sup>5</sup> Act no. 2/1993, Coll.

<sup>6</sup> Finding no. IV. US 666/02.

<sup>7</sup> Judgement no. 2 Afs 178-2005 – 64.

### II. 1.2 *The Constitution of the Czech Republic*

The Constitution of the Czech Republic<sup>8</sup> states in article 10 that the international treaties, which are ratified by Parliament and published in the Collection of international treaties, form a part of the Czech legal system. If an international treaty stipulates something that departs from domestic law, the provision of the international treaty prevails.

## II. 2 **Statutory provisions and regulations**

### II. 2.1 *The substance-over-form rule*

The Act on the Administration of Taxes and Fees<sup>9</sup>, which entered into force on 1 January 1993 in the Czech Republic, included the substance-over-form rule in article 2 (7) as follows: “*When applying tax laws in tax proceedings, the actual content of the legal act or other fact decisive for the determination or collection of the tax is always taken into account if it is covered by a formally legal act and differs from it.*”

The Tax Code<sup>10</sup> superseded the above-mentioned act on 1 January 2011. The substance rule included in its article 8 (3) was given a new wording as a consequence of case law, namely: “*The tax authority goes by the real content of a transaction or another substance which is decisive for tax administration.*”

Both the Act on the Administration of Taxes and Fees and the Tax Code have been exercised as *lex generalis* to other tax acts, such as the Income Taxes Act and the Value Added Tax Act. The substance rule is relevant for all taxes levied in the Czech Republic and entitles the tax authorities to review any transaction of the taxpayer for a real substance. The taxpayer generally bears the burden of proof. However, according to article. 92 (5) of the Tax Code, the tax authority is obliged, among other things, to prove the facts that are decisive for the assessment of the actual content of a legal act or another fact or facts rejecting the veracity of documents provided by a taxpayer.

#### II. 2.1.1 *Case law*

These sets of judgements by the SAC could show how difficult it was to understand the substance-over-form rule properly at the beginning and to find the boundaries within which to apply the rule and the abuse-of-law doctrine. These judgements have been discussed by tax professionals, academics and the public sector and have impacted future cases and new legislation, e.g. the new wording of article 8 (3) of the Tax Code.

##### II. 2.1.1.1. Corporate Income Tax – judgement no. 1 Afs 73/2004-89<sup>11</sup>

The SAC described the substance-over-form rule in its judgement no. 1 Afs 73/2004-89 as follows: “*The dissimulation according to article 2 (7) of the Act on the Administration of Taxes*

<sup>8</sup> Act no. 1/1993, Coll.

<sup>9</sup> Act no.337/1992 Coll.

<sup>10</sup> Act no. 280/2009 Coll.

<sup>11</sup> Judgement no. 1 Afs 73/2004 - 89

*and Fees can only occur when the contracting parties are simulating a certain legal act, but in fact they are not willing to do so, so they are dissimulating another legal act which they really want, or eventually they are dissimulating with it another legal act. It is decisive for the application of this rule to analyse the link between the will and the declaration of will of the contracting parties. The tax authorities are obliged to mention not only the factual legal act, which is dissimulated by a formal legal act, but also to mention in a reviewable manner their considerations leading to their conclusion, including the indication and the evaluation of proofs on which they base their findings.”*

#### II. 2.1.1.2. Personal Income Tax – judgement no. 1 Afs 11/2010-94<sup>12</sup>

In its judgement no. 1 Afs 11/2010-94, the SAC ruled, *“The exceptional application of the general principle of the prohibition of the abuse of law comes into question only if no other relevant rule of law is applicable, e.g. the dissimulation according to article 2 (7) of the Act no. 337/1992 Coll., on the Administration of Taxes and Fees. It is impossible to mix the dissimulation and the general principle of the prohibition of abuse of law in tax proceedings. The tax authorities do not have the possibility to make an arbitrary decision, if in a certain situation they apply the abuse-of-law doctrine or if, on the contrary, they take into account a factual (dissimulated) legal act instead of a simulated legal act.”*

#### II. 2.1.1.3. Value Added Tax – judgement no. 1 Afs 3/2004-63<sup>13</sup> and no. 5 Afs 121/2006-82<sup>14</sup>

The SAC delivered this statement in its judgement no. 1 Afs 3/2004-63 and no. 5 Afs 121/2006-82 concerning the substance-over-form rule: *“For the exemption of VAT in terms of article 35 of the Act no. 588/1992 Coll., Value Added Tax, and in connection with article 2 (7) of the Act no. 337/1992 Coll., on the Administration of Taxes and Fees, it is insubstantial whether an agreement for the sale of a business had actually been concluded, or whether it has been factually fulfilled by a set of legal acts formally specified in another way.”*

### II. 2.2. The abuse-of-law doctrine in tax law

The judge-made law and case law in the legal system of continental Europe is progressively gaining significance. This progress is influenced not only by decisions of the ECJ, but also by the demand of judiciary practice in order to solve complicated cases. The case law of superior courts has been considered as a source of law in Czech technical literature.<sup>15</sup>

The abuse of law had been exclusively considered as an institute of the civil law until 2005. But since that year, the abuse-of-law doctrine has been embedded in Czech tax law through the case law.

#### II. 2.2.1. Case law

The judgement no. 1 Afs 107/2004-48 of the SAC was the first ruling to apply the abuse of law in Czech tax law. This leading case and its impact on legislation is described in the next

<sup>12</sup> Judgement no. 1 Afs 11/2010-94

<sup>13</sup> Judgement no. 1 Afs 3/2004-63

<sup>14</sup> Judgement no. 5 Afs 121/2006-82

<sup>15</sup> Harvanek Jaromir a kol, *Teorie prava, Vydavatelství a nakladatelství Ales Cenek, s.r.o.*, 2008, ISBN 978-80-7380-104-5, p. 290.

subchapter. Furthermore, other case law concerning the abuse-of-law doctrine related to corporate income tax and VAT, is mentioned. The SAC has also delivered several judgements in the area of the tax code<sup>16</sup>, but the resolved and pending cases mainly cover income tax or VAT.

The Czech courts are significantly influenced by the ECJ case law regarding the abuse of law and follow its tests in principle. In Czech case law, besides the tests elaborated by the ECJ concerning the abuse of law, a request appears for the existence of unjustified harm of another individual or legal entity, meaning that a taxpayer reduces the tax income of a state which could otherwise be redistributed for the benefit of other members of society in accordance with the law.<sup>17</sup>

The Czech judiciary is still developing the abuse-of-law doctrine through its case law. In some cases, the abuse of law was approved and the tax was retrospectively assessed; in other cases, the argumentation of the tax authority or regional court concerning the abuse of law was denied.

### *II. 2.2.1.1. Personal Income Tax*

The judgement no. 1 Afs 107/2004-48<sup>18</sup>, delivered by the SAC, and the finding no. US 374/06 of the Constitutional Court have developed the abuse-of-law doctrine in Czech tax law.

The situation: an individual and his relatives established a civic association according to relevant law in 1999. The members of this association were this individual and his relatives only. The aim of this legal entity was mainly:

- to develop sports activities for the association’s members, leading to the extension of their education,
- to support their cultural and artistic activities,
- to protect animals and the environment,
- to deal with other domestic and international sports clubs,
- and an active participation by organizing cultural and sports events.

The individual reduced his tax base in the 2000 and 2001 tax periods by making financial donations to this civic association according to art. 15 (8) of the Act no. 586/1992 Coll., Income Taxes Act (“ITA”). The individual confirmed these facts in May 2002. In 2000, art 15 (8) primarily stipulated: “*You can deduct from your tax base the financial donations given to municipalities and legal entities in the Czech Republic for financing science and education; research and development; culture; the educational system; the police; fire protection; the support and protection of young people; the protection of animals; the social, health, ecological, humanitarian, charity and religious purposes of registered denominations and religious companies; sports clubs; and those donations given to political parties and political movements for their activities; and furthermore those donations given to individuals with permanent residence in the Czech Republic operating educational and health facilities and institutions for the protection of abandoned animals or endangered species; for financing these institutions if the total amount of donations exceeds two percent of the tax base in the relevant tax period or amounts to a minimum of CZK 1,000. In total, it is possible to deduct a maximum of 10 per cent of the tax base.*” In 2002, the tax authority began a

<sup>16</sup> E.g. Judgement no. 1 Afs 101/2007-49

<sup>17</sup> E.g. Judgement no. 2 Afs 173/2005-69

<sup>18</sup> Judgement no. 1 Afs 107/2004-48

tax audit of this individual that focused on financial donations that he had given to this civic association in the 2000 and 2001 tax periods. The tax authority assessed tax for the individual for 2000 and 2001 retrospectively. The tax authority, or more precisely its appellent body, concluded that the individual did not need to establish a civic association and pay for the family's needs solely through this association, which was decisive even though the reality had been dissimulated by the formal legal act according to art. 2 (7) of the Act of the Administration of Taxes and Fees, no.337/1992 Coll., and found that the individual violated the provisions of article 15 (8) ITA. The expenses, which were paid only to cover the individual's family's needs, are not deductible as donations mentioned in article 15 (8) ITA.

The individual brought the case to the court. The Regional Court approved the decision of the tax authority and rejected the individual's petition. The individual appealed to the SAC and asked two questions:

- a) Was the civic association a legal entity recognised in article 15 (8) ITA?
- b) Did the purpose of the transaction used by the individual match the purpose mentioned in article 15 (8) ITA, was the purpose of this transaction not in accordance with the law or was it not an evasion of the law, and whether the individual could deduct the financial donation given to the civic association from the individual's tax base?

The SAC approved that the civic association was a legal entity according to article 15 (8) ITA. The SAC further approved that: *"The financial donations given to the civic association have been used by the civic association for financing the sport, educational and cultural activities of its members. The deduction of these financial donations from the individual's tax base is not the exercise of a right but the abuse of law. The SAC considers the individual's behaviour to be illegitimate according to the principle of the reasonable arrangement of relationships in society, since the individual and his relatives used the civic association for financing the activities of their children. There is no doubt that the individual did it in order to reduce his tax base. It is absurd to imagine that the legislator designed the fulfilment of maintenance in the way the individual did."* Moreover, the SAC expressed the following: *"The abuse of law is a situation when someone carries out a subjective right to the unjustified harm of someone else or society; such behaviour, through which illegality is achieved, is only seemingly allowed... The abuse of subjective law represents a material corrective of the formal law, through which the aspect of equity has been brought into the legal system. It is not possible to see generally and with mathematical accuracy in advance, when the abuse of law – as the exception to the rule – has been used or not. The abuse-of-law doctrine has to be flexible enough to react to an infinite number of life situations, which the law, in its commonness, cannot regulate."*

In its finding mentioned above, the Constitutional Court examined the decision no. 1 Afs 107/2004-48 in a constitutional test and approved this decision as constitutional in 2007. The Court defined the abuse of law as follows: "The abuse of law (*abusus iuris*) is a behaviour seemingly allowed, which intends to achieve the result not allowed; the specific case of an abuse of law is a bullying behaviour, which lies in the fact that a person has exercised his right with the intent to cause disproportionate harm to another person. The behaviour is seemingly allowed just because the objective law cannot allow and disallow a particular behaviour at the same time; from the principle "*lex specialis derogate generali*", the result is that the prohibition of the abuse of law is stronger than the permission granted by the law. This means, if one rule of law allows a specific behaviour and another one (providing that this behaviour has been misused in this aforementioned sense) prohibits it, then this behaviour is in fact not the exercise of a right but an infringement. (V. Knapp, *Teorie prava*,

C.H.Beck, I. vydání 1995, p. 184).<sup>19</sup> The Court concluded that the exercise of a right, which is abused, is not protected by the court.

### II. 2.2.1.2. Value Added Tax

The SAC judgement no. 2 Afs 178/2005-64<sup>20</sup>, confirmed by the extended senate SAC judgement no. 7 Afs 54/2006-155<sup>21</sup>, applies the Halifax principles to a domestic VAT case arising even prior to the Czech Republic's EU accession in 2004.

The Courts stated that:

- The objective analysis of the prohibited abuse of law must be in harmony with the principles of legal certainty and the protection of legitimate expectations. Therefore, the taxpayer has the right to know upfront what his tax situation will be, and thus must have the right to rely on the simple meaning of the words of legal regulations.
- Taxpayers have the right to organise their businesses so as to reduce the tax burden. The choice may be based on many factors, including tax aspects with respect to VAT. No obligation exists to do business in such a way that maximises the tax income of the state. The basic principle is to select the least taxed way of doing business in order to minimise costs. On the other hand, such freedom exists only to the extent granted by the legal possibilities established by the VAT regime. The normative objective of abuse-of-law prohibitions within VAT is exactly what defines the extent of choice that the common VAT rules provide to taxpayers. Such definitions must, however, take into account the principle of legal certainty and the protection of the legitimate expectations of taxpayers.

The Court interprets that the “main purpose” of a transaction, in the meaning of Halifax, is such a purpose that, when compared with its potential other purposes, is so incomparably more important that it overshadows and marginalises the other purposes in its substance so that they can be ignored when analysing the economic sense of the transaction.

At the same time, the Court ruled that it is up to the legislator to eliminate the obstacles connected with interpreting and applying the law in the event of legislative changes. And if two possible interpretations collide, they prefer the interpretation of the tax law that protects the constitutional principles of legal certainty and the predictability of legal regulations.

The Court rejected the application of the abuse-of-law principle in this case. The taxpayer had chosen the least taxed alternative from those available, which was thus the most beneficial way of carrying out his business. Part of the economic consideration is and legitimately can be the choice to organise a business in a way that will, in its entirety – i.e. also including the tax aspects, since tax is in fact one of the expense items – be most beneficial from an economic perspective.

Using the ECJ case law, including Emsland, Italservice and Halifax, the SAC argues in many decisions. One example is case no. 5 Afs 61/2008-80<sup>22</sup> from 27 November 2008. The SAC ruled that it is impossible to accept behaviour that leads to a result that does not comply with the purpose of the law, and a legal act carried out solely or predominantly to obtain a tax benefit in a situation where no proper economic reasons exist for that act cannot be

<sup>19</sup> Finding no. US 374/06.

<sup>20</sup> Judgement no. 2 Afs 178/2005-64.

<sup>21</sup> Judgement no. 7 Afs 54/2006-155.

<sup>22</sup> Judgement no. 5 Afs 61/2008-80.

considered legitimate and in compliance with the objective of the law.

### II. 2.3. The qualification of a legal act as a reduction of the tax liability in another way

Article 23 (10) ITA stipulates: “The starting point for the determinations of the tax base is the bookkeeping maintained according to specific regulations, unless a specific regulation or this Act states differently or unless the tax liability is reduced in another way.”<sup>23</sup>

#### II. 2.3.1. Case law

##### II. 2.3.1.1. Corporate Income Tax – judgement 1 Afs 35/2007–108<sup>24</sup>

The SAC ruled in its judgement no. 1 Afs 35/2007-108 that the general principle of the abuse of law is also expressed in article. 23 (10) ITA. In this case, the SAC stated, “It is necessary to distinguish the formal level recorded in accounting from the factual level, in which it is necessary to follow, among other things, the real sense and purpose of the activities to which the incomes and expenses of a taxpayer relate.”

## II. 3. How do tax authorities deal with GAARs?

The tax authorities use GAARs included in tax legislation and also increasingly make arguments using the court-invented abuse-of-law doctrine. Since 2004, the abuse-of-law argument has increasingly appeared in more tax audits ending in court cases within all areas of tax – direct, indirect (examples for both cited above) and even tax administration.<sup>25</sup>

The number of court cases on the abuse of law registered by the SAC has increased dramatically. From zero cases prior to 2004 to 42 between 2004 and 2010, and to more than 200 (!) in the seven-year period running from 2011 to the present.<sup>26</sup> The total includes 139 VAT cases, 90 direct tax cases, and the rest were focused on other taxes, including tax administration.

In some cases, the tax authorities try to justify additional tax assessments by stating that the taxpayer did not behave “rationally”. However, there seem to be quite a few difficulties in defining what “rational” should look like in specific situations.

Often (especially in loss situations and transfer pricing audits) the tax authorities also make a general argument by referring to the Civil Code, stating that the purpose of doing

<sup>23</sup> Act no. 586/1992 Coll.

<sup>24</sup> Judgement no. 1 Afs 35/2007-108.

<sup>25</sup> E.g. Decision no. 8 Aps 2/2007-61, dated 17 April 2007, on repetitive change of seat; decision no. 7 Azs 24/2008-141, dated 21 December 2009, on requesting appointment of a specific attorney; judgement no. 7 Afs 4/2011-72, dated 4 May 2011, on detailed “technical” procedures in applying the law.

<sup>26</sup> An illustrative statistic based on simply entering the search terms “dane” (taxes) and “zneuziti prava” (abuse of law) into the search engine on the website of the Supreme Administrative Court. Some cases may be counted more times as they, for example, proceed from the first to second instance. On the other hand, not all cases registered by courts of the first instance are included, because this is not the purpose of the search engine. But it shows the trend.

business is to make a profit.<sup>27</sup> It seems that they are attempting to use this general statement as a kind of GAAR, despite the fact that there is not such an explicit rule in the tax legislation. This constitutes a huge simplification: firstly, mixing intentions with outcomes and, secondly, ignoring the very nature of doing any business, namely the fact that losses are a crystallisation of numerous risks embedded in any entrepreneurial activity.

The tax authorities respect neither the domestic nor the ECJ's case law in all cases automatically. In this case, the taxpayer himself must claim the case law as it ensues from several judgements of the SAC.

The Czech Ministry of Finance ("MF CR") and the General Financial Directorate ("GFR") usually issue other rules and recommendations in separate directives or notices on how to apply certain provisions of the tax acts in practice. The tax authority requires the implementation of these directives or notices and presents them as "soft" laws. They are like internal recommendations and methodical tools for tax authorities and are not legally binding for taxpayers. According to the jurisprudence, issued internal directives, recommendations, etc. have not been considered as a source of law and are not normative acts.<sup>28</sup>

Tax authorities and courts are reviewing transactions more frequently than ever in connection with the abuse-of-law doctrine. The application of the abuse-of-law doctrine by tax administrators is growing in practice, even though they are not allowed to do so. As a result, the taxpayer, who acts according to the law and uses the best solution offered by the law for minimising his tax assessment, does not have enough legal certainty. As a result, the principle of the legal certainty is qualified by the tax authority as the principle which is weaker than the principle of material truth. The abuse-of-law doctrine should be applied by competent authorities in connection with the case law only in exceptional cases.<sup>29</sup>

The reporters would like to end this chapter with the statement of a judge of the SAC:

*"The abuse-of-law doctrine cannot be used as a method of "saturation bombing" at any time when I, acting as a tax administrator, do not want to use common and legally anticipated tools, such as the adjustment of prices between related parties or the proof of the real purpose of expenses that the taxpayer declares as tax-deductible. In VAT, we should make it clear finally that the fraud, which is based on a "missing trader" prepared beforehand and on other subjects coming before and after him and with whose help he can deduct input VAT, is simply a tax crime and there is no reason to treat this transaction as the abuse of law."*<sup>30</sup>

## II. 4. Implementation of Czech domestic anti-avoidance provisions in international double-taxation treaties

The Czech Republic has concluded agreements on the avoidance of double taxation and the prevention of fiscal evasion with respect to income taxes with 87 countries as of 25 January 2017.

The application of domestic anti-avoidance rules is embodied in many new tax treaties or in the respective protocol amending the existing tax treaty between the Czech Republic

<sup>27</sup> Art. 420 (1) of Act no. 89/2012 Coll.

<sup>28</sup> Harvanek Jaromir a kol, *Teorie prava, Vydavatelství a nakladatelství Ales Cenek, s.r.o.*, 2008, ISBN 978-80-7380-104-5, p. 290.

<sup>29</sup> Jan Skopek, *Institut zneužití danového práva v CR a EU, Právní rozhledy 7/2017*, p. 236.

<sup>30</sup> Karel Simka, *Zakaz zneužití práva nelze používat metodou „kobercoveho bombardovani"*, Bulletin KDP CR, 1/2016, ISSN 1211-9946, p. 80.

and the respective country. The trend follows recent developments around the world. The wording in tax treaties and protocols is usually as follows: *“The provision of this Convention shall in no case prevent either Contracting State from applying the provisions of its domestic laws aimed at preventing fiscal avoidance or evasion, in particular, but not limited to, the provisions on thin capitalisation, transfer pricing and substance over form.”* The Czech Republic may rely on this provision and may apply its domestic anti-avoidance rules to prevent tax avoidance and tax evasion.

The following chart gives an overview of Czech tax treaties using the domestic anti-abuse rules dated to 25 January 2017:

Country	Tax treaty	Protocol	Effective from
Armenia	Art. 27 (2)		15 July 2009
Azerbaijan		Art. 4	16 June 2006
Barbados	Art. 27 (5)		6 June 2012
Columbia	Art. 25 (2)		6 May 2015
China	Art. 21 (2)		4 May 2011
Ethiopia	Art. 27 (1)		30 May 2008
Hong Kong	Art. 25 (2)		24 January 2012
Iran		Art. 1	4 August 2016
Jordan	Art. 27 (3)		7 November 2007
Kazakhstan		Art. 14	28 June 2016
New Zealand	Art. 25		29 August 2008
Pakistan	Art. 27 (2)		30 October 2015
Panama	Art. 26 (4)		25 February 2013
Philippines		Art. 3	23 September 2003
Saudi Arabia	Art. 27 (1)		1 May 2013
Syria	Art. 27 (2)		22 November 2009
Tajikistan	Art. 27 (3)		10 October 2007

In its judgements no. 5 Afs 42/2005-102<sup>31</sup> and no. 5 Afs 94/2005-85<sup>32</sup> of 30 November 2006, the SAC ruled for the first time on the application of the domestic GAAR (namely the substance-over-form rule) in a tax treaty context. According to the decision, the local GAAR applies even though nothing in the text of the relevant Czech (formerly Czechoslovakia) - Cyprus tax treaty of 1980 indicates that a domestic GAAR applies for the tax treaty purposes.<sup>33</sup>

The case was intensely analysed in European Taxation 10/2007, focusing on the method

<sup>31</sup> Judgement no. 5 Afs 42/2005-102.

<sup>32</sup> Judgement no. 5 Afs 94/2005-85.

<sup>33</sup> Only the new Czech – Cyprus tax treaty, dated 28 April 2009, includes a specific provision entitled “Preventing improper use of the Agreement” in s. 2 of its Protocol from the same date.

of interpreting a tax treaty by the SAC<sup>34</sup>, as follows: according to the 1977 OECD Commentary<sup>35</sup> that existed when the treaty was negotiated, to ensure the application of domestic anti-avoidance provisions in the context of tax treaties, the contracting states should expressly refer to such provisions in their treaties. The case seems to be inspired by the “factual approach” contained in the 2003 Commentary,<sup>36</sup> even though there is no explicit reference to the Commentary in the decision. This implies an ambulatory approach to the Commentary, which is not in line with the Court's earlier jurisprudence, indicating a static approach.<sup>37</sup> The analysis concludes that the Court was obviously convinced that no treaty protection can be granted in these circumstances. To reach this outcome, the Court, however, seems to depart from the principles of tax treaty interpretation established by its earlier jurisprudence, without cogent reasoning or even acknowledging the departure.

The conclusions of the analysis raise serious concerns about the stability and legal certainty for taxpayers and the case seems to be an application of anti-avoidance measures to a tax treaty on a unilateral basis.

### III. Specific Anti-Avoidance Rules in the Czech Republic

SAARs are included in the ITA. The Czech Republic applies the transfer-pricing rule and thin capitalisation, with effect from 1 January 1993. The ITA was amended and the new article 38e, concerning the tax secured by a taxpayer, was amended in the ITA on 1 January 1995. The restriction applicable to payments made to tax haven entities has been used since 1 January 2013, when the new wording of article 36 was enacted, among other things.

#### III.1. Statutory provisions and regulations

The application of provisions of domestic SAARs has been explained in directives and notices issued by the Ministry of Finance or by the General Financial Directorate. The case law also deals with SAARs. The number of related directives, notices and judgements is mentioned at the end of the subchapter.

##### *III.1.1. The transfer pricing rules*

The transfer pricing rules, in the form of the arm's length principle, have been described in article 23 (7) of the ITA and are valid both for domestic and cross-border transactions

<sup>34</sup> Tigran Mkrtchyan, *European Taxation* 10/2007.

<sup>35</sup> Para. 7 of the 1977 Commentary to art. 1 of the OECD Model Tax Convention supported also by para. 10 of the 1977 Commentary to art. 1 of the OECD Model.

<sup>36</sup> Para. 9.2 of the 2003 Commentary to art. 1 of the OECD Model.

<sup>37</sup> Judgement no. 2 Afs 108/2004-106 of 10 February 2005, in which the Court stated that taxpayers cannot be expected to follow any subsequent agreement or subsequent practice in treaty interpretation, unless incorporated into the treaty text. Furthermore, it stated that only the Commentary that existed when a treaty was negotiated may be taken into account, without reference to any subsequent amendments. See Pavel Fekar, “Nekolik poznamek k rozsudku Nejvyššího správního soudu ve věci nízké kapitalizace a související klasifikace uroku pro účely smlouvy o zamezení dvojího zdanění”, *Danový expert* 3 (2005), p. 7.

between related parties. The obligation to prepare transfer-pricing documentation has not been explicitly mentioned in the ITA, but the tax authority usually requests it during a tax audit.

According to article 92 (5) (c) of Tax Act no. 280/2009 Coll., the Tax Code, the tax authority bears the burden of proof concerning the ascertainment of the difference between the agreed price of a taxpayer and its related party and the arm's length price.

Article 23 (11) of the ITA contains the arm's length principle for the determination of the tax base of a non-resident's permanent establishment situated in the Czech Republic. The tax base of the permanent establishment shall not be lower (or the tax loss higher) than the tax base (or the tax loss) of a resident taxpayer performing the same or similar activities under similar conditions. Moreover, the provisions set out the methods for determining the tax base.<sup>38</sup>

The related sources: directive of GFR D-22, directives of MF CR: D-332, D-333, D-334, DS-146, relevant judgements of the SAC: no. 7 Afs 95/2012-47, no. 7 Afs 94/2012-74, no. 7 Afs 86/2013-21, no. 7 Afs 74/2010-81, no. 1 Afs 99/2012-52, no. 2 Afs 165/2006-114, no. 5 Afs 151/2004-73<sup>39</sup>, no. 7 Afs 53/2010-55, no. 8 Afs 51/2009-61, no. 1 Afs 101/2012-31, no. 5 Afs 85/2009-67.

### *III. 1.2. The thin capitalisation rule*

The aim of thin capitalisation mentioned in article 25 (1) (w) of the ITA is to prevent the speculative reduction of profit between related parties. Thin capitalisation applies to interest on loans and credits, including related expenses, e.g. a fee for a guarantee, a fee for processing a credit to a taxpayer from its related parties, and including back-to-back loans. The Czech Republic applies the fixed debt-equity ratio method. The ratio for banks and insurance companies is set at 6:1 and the ratio for other recipients of loans and credits is set at 4:1. The interest on the part of the loan that includes related expenses that exceed the limits, is not tax-deductible.

The related sources: directive of GFR D-22, notice of the MF CR, no. 15/33 371/2009-151, relevant judgements of the SAC: no. 2 Afs 165/2006-14, no. 1 Afs 9/2005-74.<sup>40</sup>

### *III. 1.3 Mergers, share-for-share exchange and transfer of business*

Mergers, share-for-share exchange and transfer of business enjoy special treatment. Under certain conditions, they are tax neutral with the option to transfer tax losses, provisions, reserves and certain tax credits. However, this treatment is not granted, based on article 23d (2) of the ITA, if the main or one of the main reasons for the transaction is to reduce or avoid tax liability, especially if it is apparent that there are no ordinary economic reasons for the transaction, such as restructuring or increasing the efficiency of the concerned corporations.

<sup>38</sup> Ana Paula Dourado, *Tax Avoidance Revisited: Exploring the Boundaries of Anti-Avoidance Rules in the EU BEPS Context*, EATLP 2016.

<sup>39</sup> Vladimír Pelc, Petr Pelech, *Dane z prijmu s komentarem 2016*, nakladatelství Anag, 2016, ISBN-978-80-7554-011-9, p. 379-281.

<sup>40</sup> Vladimír Pelc, Petr Pelech, *Dane z prijmu s komentarem 2016*, nakladatelství Anag, 2016, ISBN-978-80-7554-011-9, p. 499-500.

The source: art. 23d (2) of the ITA.

### *III. 1.4. The withholding tax applicable to payments to tax haven entities*

The withholding tax applicable to payments made to tax haven entities is a kind of restriction and is stipulated in article. 36 (1) (c) of the ITA. The income specified in article 36 (1) (a) and (b) of the ITA that is derived from the source in the Czech Republic by a taxpayer who is not a resident of an EU member state nor of a country in the European Economic Area nor a resident of a country with which the Czech Republic has concluded a valid and effective tax treaty, a tax information exchange agreement, a multilateral agreement providing for exchange of information of which both the Czech Republic and that country are a party, has been subject to withholding tax at the rate of 35 per cent. This withholding tax is always final.

The related sources: directive of GFR D-22 and notice of GFR no. 50098/12-3130-11042.

### *III. 1.5. The tax secured by a taxpayer*

The tax secured by a taxpayer has been stipulated in article 38e of the ITA since 1 January 1995. If the income of a non-resident is not subject to withholding tax in the Czech Republic, then the institute of the tax secured at a certain rate (1 per cent for investment instruments, 10 per cent for income derived from a Czech source, 15 per cent for individuals, 19 per cent for legal entities such as a partner in a partnership or general partner in a limited partnership) by a taxpayer will apply. This article regulates the circumstances in which the taxpayer is obliged to secure and pay the tax for a non-resident as an individual or for a non-resident as a legal entity, non-residents of any member state of the European Union or other member states in the European Economic Area. The taxpayer has to file a special tax report and pay the tax secured. The tax secured paid by a taxpayer may be credited to the non-resident's whole amount of tax or if, for example, a loss occurs, the tax secured will be paid back to the non-resident at the end of the taxable period. The tax secured is treated as an advanced tax payment if the non-residential taxpayer files his income tax return in the Czech Republic according to this provision. If no income tax return is submitted, the tax paid by a taxpayer for a non-resident is taken for granted as being a final tax imposed.

The related sources: directive of GFR D-22, related judgement of the Municipal Court of Prague no. 28 Ca 323/2001-36, related judgement of the Regional Court of Ceske Budejovice no. 10 Ca 100/99-26.<sup>41</sup>

<sup>41</sup> Vladimír Pelc, Petr Pelech, Dane z příjmu s komentářem 2016, nakladatelství Anag, 2016, ISBN-978-80-7554-011-9, p. 693.

## IV. Position of the Czech Republic with respect to recently adopted or discussed changes inspired by the OECD's BEPS project and the EU Council Directive against tax avoidance

The international activities combatting tax avoidance, e.g. OECD/G20 Base Erosion and Profit Shifting Project and the directive against tax avoidance issued by the EU, impact Czech tax law. The recently signed multilateral instrument that amends double-taxation treaties and part of the discussion paper issued by the Czech MF CR concerning international activities to combat tax avoidance in direct taxes are described.

### IV. 1. Multilateral instrument amending double-taxation treaties

The Czech Republic is one of 68 signatories to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, ("multilateral instrument") of 7 June 2017. The multilateral instrument offers concrete solutions for governments to close the gaps in existing international tax rules by transposing results from the OECD/G20 BEPS Project into bilateral tax treaties worldwide. The multilateral instrument modifies the application of thousands of bilateral tax treaties concluded to eliminate double taxation. It also implements agreed minimum standards to counter treaty abuse and to improve dispute resolution mechanisms while providing flexibility to accommodate specific tax treaty policies.<sup>42</sup> This multilateral instrument is subject to the ratification and approval process according to the domestic law. It is expected that the ratification and approval process will be finished in the beginning of 2018.

The multilateral instrument covers 87 double taxation treaties which the Czech Republic has concluded over the years with other contracting states. The Czech Republic took a position that limits its commitment to the minimum standards. This means that only articles 6, 7 and 16 of relevant double taxation treaties should be updated. Article 6 will contain a new preamble, which stipulates that the aim of the double taxation treaties is to prevent double taxation and simultaneously prevent tax avoidance in respect of income taxes and taxes on capital gains. Article 7 will, among other things, expressly specify the option to limit treaty benefits in the case of their abuse. Article 16 suggests a better mechanism for settling disputes concerning double taxation.

The following chart describes the position of the Czech Republic on the structure and content of the multilateral instrument. If there is a yes, the Czech Republic has accepted it; if there is a no, the Czech Republic has not accepted it.<sup>43</sup>

<sup>42</sup> <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>.

<sup>43</sup> <http://ifa.pef.czu.cz/> - IFA travelling lectureship programme 2017– comprehensive seminar on the implementation of the MLI and other BEPS related issues.

<b>Part II. Hybrid mismatches</b>	Transparent entities (codification of OECD partnership recommendation)	No
	Dual resident entities	No
	Application of methods for the elimination of double taxation	No
<b>Part III. Treaty abuse</b>	Amendment to preamble of double taxation conventions (no “opportunities for the non-taxation or reduced taxation through tax evasion or avoidance”)	Yes
	Principal purpose test with discretionary relief under article 7 (4)	Yes
	Dividend transfer transaction (subject to double taxation treaties already containing a holding period)	No
	Capital gains in real estate companies	No
	Anti-abuse rule for PEs in third jurisdictions	No
	Savings clause	No
<b>Part IV. Avoidance of PE status</b>	Artificial avoidance of PE status through commissionaire arrangements and similar strategies	No
	Splitting up of contracts of PE	No
	Definition of closely related persons to enterprise	No
<b>Part V. Improving dispute resolution</b>	Commitment to apply a mutual agreement procedure to resolve disputes	Yes
	Corresponding adjustments pursuant to article 17 (3)(b)	Yes
<b>Part VI. Arbitration</b>	Mandatory arbitration upon request of the taxpayer when states fail to agree in a mutual agreement procedure	No

#### **IV. 2. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (“ATAD”)**

This directive will bring new instruments, such as the interest limitation rule, exit taxation, GAAR, controlled foreign company rule and hybrid mismatches, into Czech tax law and the necessity to essentially amend the ITA with these instruments, expected to take effect on 1

January 2019. The discussion on this topic was open until 30 April 2017.<sup>44</sup>

Article 7 of ATAD proposes to implement GAAR that should allow tax authorities to deny benefits for taxpayers resulting from artificial transactions without economic substance whose aim is to reduce tax.

The position of the Czech Republic is that provisions of Czech tax legislation and case law in which the courts apply the substance-over-form rule cover this issue. For this reason, it is not necessary to implement it with a specific rule.<sup>45</sup>

## Addendum

The Ministry of Finance has prepared an amendment to the Tax Code, where it proposed to explicitly include (in the section 8) a GAAR - a rule disregarding acts, which abuse the law. Our informative translation of this provision is as follows: *“Tax administration disregards legal acts and other dealings, the main or one of the main purposes of which is to obtain a tax or other advantage contrary to the spirit and purpose of the law.”*

This new piece of drafted legislation is in the comment procedure until the beginning of March. After that, it should be submitted to the Parliament and the legislation process should begin.

This is a shift as based on a previous statement of the Ministry (also mentioned in this report), the Ministry held the view that it is not necessary to update the Czech tax legislation by introducing a specific provision on GAAR.

<sup>44</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L1164&from=en>

<sup>45</sup> Mezinárodní iniciativy proti vyhybání se danovým povinností v oblasti primých daní, verze k 22. dubnu 2016, k diskusi, Ministřtvo Financí, 2016 – pracovní text, p.38, available at [www.mfcr.cz/assets/cs/media/Dane\\_Material\\_2016\\_BEPS\\_1.pdf](http://www.mfcr.cz/assets/cs/media/Dane_Material_2016_BEPS_1.pdf)



International Fiscal Association

ISBN 978 90 12 40204 0



9 789012 402040

Sdu