Rödl & Partner

NEWSLETTER CZECH REPUBLIC

Issue: December 2022

Information on Law, Taxes and Economics in the Czech Republic

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Czech Law Firm of The Year 2022

Czech Law Firm of the Year 2012–2022

Rödl & Partner

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→ Law

Earn-out as a means of spreading risk

The valuation of a company and the determination of the purchase price based on such valuation is usually based on a plan and forecast of the future sustainable earnings of the target company ascertained according to the current business development.

Hans-Ulrich Theobald
Rödl & Partner Prague

The expectations of sellers and buyers may differ significantly, particularly given the flailing global economy.

Sellers are generally unwilling to provide assurances as to the future development of the target company's business. This is particularly true if they cannot influence its economic activity after the sale.

In order to avoid the seller being forced to accept discounts on the purchase price in light of uncertain developments or potential risks and to ensure that the buyer, on the other hand, has relative certainty about the development of factors relevant to the future value of the target company, the parties can avert to negotiating an earn-out mechanism in the sale and purchase agreement.

The earn-out mechanism is a purchase price arrangement whereby a part of the purchase price will be paid to the seller in the future, with the accrual, maturity and entitlement to the purchase price depending on the target company achieving certain indicators at specified future periods. These periods are typically two to three years and the variable part of the purchase price typically accounts for 20 to 40 per cent of the purchase price.

In cases when the success of the target company has been significantly linked to the seller (e.g.: The seller has been involved in the target company's operational activities as a managing director or harbours personal contacts with customers), the earn-out mechanism can be used to get support from the seller, at least for a transitional period. The seller will be motivated to contribute to the ongoing success of the target company's business. However, care must be taken to ensure that the agreed future targets are realistic, as unattainable targets are disincentive and may generally prevent the parties from reaching an agreement.

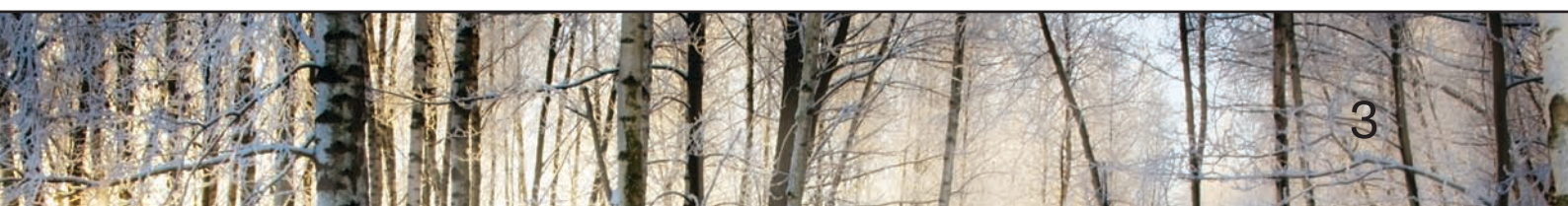
In practice, when negotiating an earn-out, care should be taken to ensure that the interests of both parties are adequately taken into account. Given the complexity of setting up the mechanism, the following issues should always be clarified:

- The conditions governing the establishment of entitlement (indicators, other conditions, e.g. compliance with the competition clause);
- The period for which the earn-out is agreed, the basis of calculation, the amount and the calculation;
- Identification of economic data and the review thereof;
- The ability of the seller and buyer to influence the future business activities of the target company during the period for which the earn-out is agreed;
- Security for future payment by the buyer (for example, escrow account deposit, bank guarantees, surety bonds) and the use of that part of the purchase price to secure any of the buyer's claims.

We have noticed an increase in the use of earn-out arrangements in transactions, particularly in recent years, the reason being that they allow for a reasonable allocation of risks and opportunities between the parties, thereby aligning the seller's and buyer's positions so that an agreement can be reached.

Contact details for further information

Hans-Ulrich Theobald
advokát / Attorney-at-Law
Partner
P +420 236 163 730
hans-ulrich.theobald@roedl.com



→ Taxes

Amendment to the VAT Act effective 1 January 2023

On 25 November 2022, the Senate approved a draft tax package that includes, among other things, an amendment to the Value Added Tax Act. The amendment is expected to come into effect on 1 January 2023 along with a number of transitional provisions. Unlike previous amendments, this one is short and sweet. But fear not, it does contain several changes worth mentioning.

Klára Sauerová, Johana Cvrčková
Rödl & Partner Prague

Higher turnover and the VAT registration obligation

Currently, an entrepreneur established in the Czech Republic is obliged to register as a VAT payer the minute they exceed an annual turnover of CZK 1 million for transactions with a place of supply in the Czech Republic. The said limit was set in 2004, has not been reviewed since, and no longer fully corresponds to the economic criteria of today. As of 1 January 2023, the turnover limit will increase to CZK 2 million, which will give small entrepreneurs and companies in particular more room to steer clear of the VAT system, if that is what they prefer, even if they earn more than CZK 1 million by the end of 2022. Transitional provisions give existing taxpayers with a turnover of more than CZK 1 million but less than CZK 2 million the option to cancel their VAT registration.

Penalties for VAT control statements halved for some taxpayers

Deadline for responding to the tax authority's request for a VAT control statement

When the tax authority identifies discrepancies or differences between business partners in submitted VAT control statements, it will initiate proceedings and invite the taxpayer to amend, supplement or confirm the information provided in said statement. The time limit for the taxpayer to respond is currently five working days from receipt of the notice, i.e. usually when the taxpayer collects the tax authority's request for cooperation from their data box.

The deadline has been reviewed under the amendment and, if the notice is delivered to the taxpayer's data box, the deadline will now be seventeen days from when the notice is delivered to the taxpayer's data box. Delivery means the moment when the notice arrives in the data box, not when the taxpayer collects the notice. If the notice is delivered by other means, the time limit of five working days will continue to apply.

Deadline for responding to a call to file a VAT control statement extended

Mitigation of penalties for misconduct related to VAT control statements

The law provides for various penalties for taxpayers for misconduct related to late filing or failure to file a VAT control statement. The penalties are as follows:

- CZK 10,000 if the taxpayer files a VAT control statement within the extended deadline set by the tax authority;

- CZK 30,000 if the taxpayer fails to submit the VAT control statement following the tax authority's request to amend, supplement or confirm the data originally claimed;
- CZK 50,000 if the taxpayer altogether fails to submit the VAT control statement even given the extended deadline.

The penalties will be half the amount after the amendment. This, however, only applies to taxpayers who are natural persons, to taxpayers who have a quarterly tax period, and to limited liability companies with only one member, provided the member is a natural person.

If you have any questions, please contact the authors of this article or the tax team you work with at our firm.

Contact details for further information

Ing. Klára Sauerová
daňová poradkyně
(Tax Advisor CZ)
Associate Partner
P +420 236 163 280
klara.sauerova@roedl.com

Ing. Johana Cvrčková
daňová poradkyně
(Tax Advisor CZ)
Senior Associate
P +420 236 163 249
johana.cvrckova@roedl.com

→ Taxes

More time for extraordinary depreciation

Much light has recently been shed on windfall tax. What's more, another newbie, perhaps a positive one, is lurking in the shadows of the same amendment to the Income Tax Act; the government is aiming to extend the possibility of claiming extraordinary depreciation. Currently, extraordinary depreciation applies to assets classified in Depreciation Groups 1 and 2 and acquired between 1 January 2020 and 31 December 2021. Assets in Depreciation Group 1 can be written off over a period of twelve months and assets in Depreciation Group 2 can be written off at 60% of the cost in the first twelve months and at the remaining 40% in the following twelve months.

The amendment extends the possibility of applying extraordinary depreciation to assets acquired before 31 December 2023.

Contact details for further information

Ing. Martina Šotníková
martina.sotnikova@roedl.com

→ Taxes

Windfall tax

Facing ongoing military conflict in Ukraine and the energy crisis, the government has introduced a windfall tax to boost the state budget.

Michael Pleva, Adéla Gabrielová
Rödl & Partner Prague

The tax package, which also includes windfall tax, has already passed its third reading in the Chamber of Deputies and has been approved by the Senate. Windfall tax should be in effect from 2023 to 2025, notwithstanding earlier reports that it would take effect as early as 2022. The important thing is that advances on the tax are to be paid as early as the second half of 2023.

Who will have to brave windfall tax?

Windfall tax is aimed at companies primarily engaged in electricity and gas production and trading, banking, fossil fuel extraction and the production and distribution of petroleum and coke products. In the banking sector, the criterion will be the net interest income achieved in the 2021 reporting period. The limit is set at CZK 6 billion. In the energy production and distribution sector (e.g. electricity distribution), the turnover for the entire holding in 2021 will be assessed. If the holding has a turnover of at least CZK 2 billion from these activities, it will be subject to windfall tax. Nonetheless, it applies to both categories, that the taxpayer must have a taxable income of at least CZK 50 million.

Other companies operating in the petrochemical, coking and fossil fuel extraction sectors are required to have a CZK 50 million revenue from these critical activities. Moreover, the revenues from these activities will have to account for at least 25 per cent of their net turnover for the previous year. The threshold will ensure that windfall tax will not be applied to small companies that have only marginal revenues from said activities.

Tax calculation

Windfall tax will not be calculated on the entire tax base, but only on excess profit. Excess profit will be determined as the difference between the tax base in the current period and the average tax base for the period 2018 to 2021. The average will be increased by a so-called tolerance band of 20 per cent. The tax base exceeding the average tax base thus increased will be subject to a tax rate of 60 per cent. The aim is to introduce a mechanism that would ensure that only excess profit that may have been made because of the energy crisis is taxed.

If your company meets the windfall tax criteria and you have any questions, please do not hesitate to contact us.

Windfall tax

Contact details for further information

Ing. Michael Pleva
daňový poradce
(Tax Advisor CZ)
Associate Partner
P +420 236 163 232
michael.pleva@roedl.com

→ Taxes

Electronic Registration of Sales (EET)

Eagerly expected by many, the government plans to drop electronic sales registration. Entrepreneurs are no longer required to use the EET application. MPs have already approved the abolition of the EET and the amendment is awaiting the Senate's consideration and the President's signature.

Contact details for further information

Ing. Martina Šotníková
martina.sotnikova@roedl.com

→ Taxes

Supreme Administrative Court has unique view on cash-pooling

A recent judgment of the Supreme Administrative Court concerning cash-pooling between related parties is the first of its kind.

Martin Koldinský
Rödl & Partner Prague

At the end of October, the Supreme Administrative Court (SAC) issued a very interesting and so far unique decision regarding intra-group financing (cash-pooling), which is an area on which the SAC has not yet commented.

The case is quite complex. Put simply, the tax authority assessed the difference between the original interest rates that the taxpayer received for the funds it provided to related parties under cash-pooling and the new, adjusted rates. The interest rates differed quite significantly, since before the new agreement was concluded the taxpayer received interest at 1M PRIBOR + 3 % on deposits and paid interest at 1M PRIBOR + 3,75 % on borrowed funds. The difference between deposits and drawdowns was therefore not very significant. The cash-pooling principle changed when the contractual arrangements changed. The taxpayer's deposits were then subject to interest at 1M PRIBOR + 0,17 % and its borrowings were subject to interest at 1M PRIBOR + 4,5 %.

In assessing the tax liability resulting from the tax audit, the tax authority relied on the original contractual arrangement, which allegedly stated that the taxpayer could request an adjustment of the interest rates if they were not, in its view, arm's length. Since the taxpayer did not do so, the tax authority considered that the original interest rates were arm's length - as opposed to the new rates. Therefore, without establishing the correct reference (arm's length) interest rate, the tax authority assessed the difference between the original and the new rate.

According to the Supreme Administrative Court, the tax authority only required the tax-

payer to explain the difference between the original interest rate and the new interest rate, without specifying the reference price (interest) against which the interest between the related parties should be compared. In so doing, according to the SAC, the tax authority erred and failed to meet its burden of proof.

The tax authority argued, among other things, that cash-pooling is very specific and essentially incomparable to other financial instruments and that is why it could not find a reference price. In this respect, according to the Supreme Administrative Court, the tax authority was obliged to use, for example, interest rates on bank accounts and to adjust them accordingly, with the help of an expert, for example, in order to establish a reference price.

The fact that the taxpayer cooperated with the tax authority during the tax audit and produced evidence to prove its claims was in the taxpayer's favour, but the tax authority did not take this information into account.

The Supreme Administrative Court's ruling only confirms that intra-group financing is coming to the fore and will continue to be the subject of more frequent disputes between tax authorities and taxpayers. Changes in interest rates are of course common, especially in the context of present-day financial market conditions. However, each and every change must be reasonable sense, particularly from an economic point of view, and must be thoroughly documented so that this economic rationale can be demonstrated to the tax authorities; this applies by analogy to the arm's length principle.

Contact details for further information

Ing. Martin Koldinský
soudní znalec
(Judicial Expert CZ)
Associate Partner
P +420 236 163 750
martin.koldinsky@roedl.com

→ Rödl & Partner Intern

11th time in a row: Rödl & Partner as The Law Firm Of The Year for 2022

Rödl & Partner is once again celebrating a win. In the Law Firm of the Year ranking, the firm was voted Law Firm of the Year in Tax Law for the eleventh time in a row, confirming its excellence in this field. It also won recognition in other categories. As a highly recommended firm in the areas of logistics and transportation engineering and healthcare law, and as a recommended firm in corporate law, real estate development and real estate projects, mergers and acquisitions, and dispute resolution and arbitration.

Jana Švédová
Rödl & Partner Prague

Tax law occupies a prominent position at Rödl & Partner. Both experienced attorneys and highly-qualified tax advisors bring their specialised skill sets to this field. Thanks to this combined expertise, the firm can offer its clients a one-stop solution to all tax issues. The tax litigation team represents the crème de la crème of our tax advisory services, as the firm's multidisciplinary approach enables the team to resolve the issues facing our clients with maximum effectiveness.

"We are much appreciative of the award for the Law Firm of the Year 2022, for the eleventh time in a row, in the field of tax law. For us, this represents a truly exceptional recognition of the competence we have worked so hard to develop over the years," stated Petr Novotný, managing partner of Rödl & Partner.

He further added: "I am very pleased that our law firm is ranked among the best in this field and that the market perceives us as specialists in tax law, an area in which we have been specializing for a long time." Rödl & Partner was historically one of the first advisory firms to build a tax litigation team focusing on representing clients before the tax authorities and courts.

"Tax law is a multi-faceted and rather complicated area of law that is constantly evolving and undergoing dynamic development," commented Jakub Šotník, an attorney from the tax litigation team. Kateřina Jordanovová added that legislative changes come not only from the national legislature, but also from the international environment. Continually developing and increasing know-how is a fundamental precondition for successful consulting.

Rödl & Partner also received awards in the following other categories:

Highly recommended firm in the categories of:

- Logistics and transportation engineering
- Healthcare law

Recommended firm in the categories of:

- Corporate law
- Real estate development and real estate projects
- Mergers and acquisitions
- Dispute resolution and arbitration

This is a tremendous achievement for the entire team of lawyers, to whom many thanks are due for their unparalleled dedication to client service.

Our success is also a message to our clients – you are in good hands.

"Solving the problems faced by our clients is what drives us to continually hone our expertise. We are thrilled and very grateful that this expertise has been recognized by an award that puts us at the top of the law firm rankings in this area," added Rödl & Partner partner Monika Novotná.

We would also like to give our profound thanks to E-PRAVO.CZ for long-term cooperation and for organising the Law Firm of the Year awards, which E-pravo.cz has been doing every year for the last fifteen years.

The Law Firm of the Year Award was created in 2008 and was inspired by foreign awards ranking legal firms (Chambers Global, PLC, IFLR 1000, Legal 500), which have a longstanding tradition in the West. In the Czech Republic, the award is announced annually by EPRAVO.CZ. This year's 15th award ceremonies took place under the patronage of the Minister of Justice of the Czech Republic and the Czech Bar Association.

Contact details for further information

JUDr. Petr Novotný, Ph.D.
advokát
(Attorney-at-Law CZ)
Managing Partner
P +420 236 163 770
petr.novotny@roedl.com

Ing. Jana Švédová
PR Manager
P +420 236 163 111
jana.svedova@roedl.com

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P +420 236 163 111
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Editorial board:
Ing. Jana Švédová, Mgr. Václav Vlk,
Ing. Klára Sauerová, Ing. Jaroslav Dubský,
Ing. Ivan Brož

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