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ESG in the context of transactions

ESG stands for Environmental, Social and Governance – three key factors used to assess the impact of companies on the environment, society and corporate governance.

Hans-Ulrich Theobald
Rödl & Partner Prague

ESG factors play a vital role in transactions such as acquisitions or IPOs. Companies that can demonstrate a brilliant ESG track record often have a competitive advantage in such transactions.

Investors pay close attention to how well a company performs on environmental issues, how it addresses environmental challenges such as climate change and resource scarcity, and what measures it takes to reduce its environmental impact. Investors are also generally interested in how a company approaches social responsibility, because what matters in the war for talent is how companies treat their employees, whether they offer fair working conditions and whether they promote diversity and inclusion. Investors are also interested in target companies with good governance, transparent reporting, independent supervisory bodies and adequate control mechanisms. A strong governance framework reduces the risk of mismanagement and contributes to the sustainability of the business. Positive ESG performance is often seen as an indicator of a company's long-term sustainability and profitability.

Special due diligence procedures are often carried out to adequately reflect ESG factors in transactions. These include a detailed review of the target company's ESG risks and opportunities. Extensive analysis of environmental impacts, employee relations, supply chain management and other relevant ESG aspects is conducted to assess the target company's ESG performance and identify potential risks or areas for improvement.

Where an investor acquires only a minority stake in a target company, ESG clauses are

increasingly included in transaction agreements. These clauses oblige the seller to ensure that the target company complies with certain ESG standards or implements measures to improve ESG performance. They serve to ensure that ESG factors continue to play an important role even after the transaction and that the company operates sustainably in the long term.

The inclusion of ESG in transactions also impacts the financial sector. ESG criteria are being incorporated into lending and investment decisions. This trend is expected to pick up – banks already provide limited financing for investments in certain industrial sectors.

Altogether, ESG will play an increasingly important role in transactions. Companies that neglect ESG aspects may face difficulties attracting investors or obtaining good deal terms in the future. Integrating ESG into transactions also offers opportunities, as it can help support long-term sustainability and value enhancement. It is therefore essential that companies take ESG factors seriously and incorporate them into their business practices.

Contact details for further information



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



→ Taxes

Where to draw the line between advertising and representation in terms of taxes?

The Supreme Administrative Court has recently added a new ruling to the case law on the tax deductibility of advertising costs. The current case turned on the issue whether the costs incurred for a company's 20th anniversary event, which included an accompanying programme and training for clients, were tax deductible. The Supreme Administrative Court found that the event was not an advertising opportunity as claimed by the taxpayer, but rather a promotion of the company as such. So where does the line lie between advertising and promotion in terms of taxes?

Jakub Šotník
Rödl & Partner Prague

The company held a social gathering for its clients to mark the 20th anniversary of its founding. On this occasion, a new logo was presented and a training session was organised for clients, including a presentation of the company's history, achievements, new strategy and corporate style, new visions and directions in which the company would develop further. Incoming guests were welcomed by hostesses and they could have fun and socialise playing billiards, bowling, laser tag, or even trying their luck at a golf simulator, for example. There was also a photo booth, sauna and jacuzzi. The event was moderated, people could dance to the beat of both a music band and a DJ. A magician brought the evening to a sweet close.

The company argued that the event was a client event designed to build brand position and corporate recognition. Tax and administrative authorities, however, were of the opposite opinion. According to the administrative authorities, it was a social representative event intended for the direct consumption of business partners – clients, and was not a promotion of specific products or services of the company. At the same time, the nature of the event should have been apparent from the title of the event itself, i.e. ... 20 years – event for clients – social gathering – priority is to relax, enjoy and try interesting activities (shooting, golf, etc.).

The Supreme Administrative Court confirmed that the tax authority and the administrative authorities correctly assessed the event as a non-tax deductible expense for the promotion of the company. However, the Supreme Administrative Court acknowledged that there is a fine line

between representation and advertising and it will always depend on the specific circumstances; while for one taxpayer an expense may be tax deductible, for another it may not be. The Supreme Administrative Court admitted that it saw a difference between a peaceful event during which a presentation of products is followed by a business meeting and a pompous event.

According to the Supreme Administrative Court, the costs of advertising must therefore always be assessed in the light of the process of persuasion, in which new users of goods and services are sought. On the contrary, representation costs already represent a supply which is intended for direct consumption or for gift-giving.

It is clear from the conclusions of the Supreme Administrative Court described above that, when assessing the tax deductibility of advertising costs, it is not only the tax documents and the taxpayer's claims that will be assessed, but also the actual nature of the specific performance, the relationship between the accompanying and training programme and, where appropriate, how the event was called and promoted among the participants.

Contact details for further information



Mgr. Jakub Šotník
advokát
(Attorney-at-Law CZ)
Associate Partner
P +420 236 163 210
jakub.sotnik@roedl.com



→ Taxes

SAC rules in an interesting case of IC services

The Supreme Administrative Court (SAC) has ruled on the tax deductibility of costs for IC services. The case was about three categories of services (consultancy services for production; support services relating to HR, IT, sales, marketing, finance and law; loan refinancing services), the costs of which were assessed by the tax administrator as tax ineffective, which was subsequently confirmed by the Regional Court in Pilsen.

Petr Tomeš
Rödl & Partner Prague

This is yet another of many rulings on IC services that are very often in the crosshairs of various tax authorities. During tax audits, they require the tax entity under scrutiny to prove how the remuneration was calculated (especially in terms of cost allocation to individual recipients of services using allocation keys); the tax entity is also required to prove the actual course of the services and their benefit to the recipients.

This was also the case in the present case, where the tax authority questioned the costs of the services in question and considered the evidence submitted to be inconclusive. In the case of production services, the remuneration was based on the value of the savings achieved in production, where the tax authority questioned the link between the services provided and the savings achieved. Part of the tax authority's doubts lay in the fact that the various supporting documents did not coincide, such as the list of services and the contractual obligation to provide a detailed description of the services invoiced.

The appellate authority and subsequently the regional court upheld the decision of the tax authority. However, the Supreme Administrative Court disagreed and concluded that the production consultancy services had been convincingly proven and had benefited the tax entity in the form of cost savings and production efficiency.

We consider the following conclusions of the SAC to be crucial:

- The SAC considered the requirements of the tax authority to specifically identify each individual piece of production advice and to exactly quantify its economic benefit to be an unreasonable requirement,
- The fact that the owner of the tax entity also benefits from the service in question is not an obstacle to tax deductibility if the tax entity itself also benefits from the service.

On the contrary, in the case of loan refinancing and support services, the Supreme Administrative Court agreed with the tax authority.

The fundamental doubts consisted in:

- Failure to document the allocation key for the allocation of costs to individual companies,
- The supporting documents to demonstrate how the remuneration was determined did not match (cost range, profit margin),
- Failure to produce the contract to which the invoices referred,
- Failure to document the specific outputs of the services used,
- The service provider employed only two staff members despite the wide range of services provided.

It follows from the above that it is certainly appropriate to keep a continuous record of supporting documents to demonstrate services, to check

their accuracy, completeness and conclusiveness and, above all, the consistency of the individual documents. Since a tax audit may take place many years after the end of the reporting period in question, we recommend that supporting documents be checked on a continual basis – definitely do not wait until the audit has begun.

On the other hand, the judgment shows that it makes sense to stand up against the unreasonable requirements of the tax authorities in the case of proving IC services, even at the cost of court proceedings.

We hope that findings like the ones described above will soon become part of established administrative practice and that tax authorities will fully respect them during tax audits.

If IC services concern you, we will be happy to offer you support both in terms of review-

ing your documentation and providing you with the necessary support during tax audits or subsequent administrative or judicial proceedings.

Contact details for further information



Ing. Petr Tomeš
daňový poradce
(Tax Advisor CZ)
Associate Partner
P +420 236 163 750
petr.tomes@roedl.com



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P +420 236 163 111
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Editorial board:
Ing. Jana Švédová, Mgr. Václav Vlč, Ing. Martina Šotníková, Ing. Jaroslav Dubský, Ing. Ivan Brož

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