JULY 2017

NEWSLETTER

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Dear readers,

This time, we have incorporated in Lerika's summer newsletter an article that you may find of interest even though it's not work-related at all. There has been a lot of heated discussions recently around the issue of the so-called one-crown bonds. However, only a handful of people had time to consider the tax and legal implications of the whole matter in more detail. This is why we are covering the topic. You may wonder what this all means for us as taxpayers. Can we venture into perilous waters of tax planning, taking the risk of being accused of abuse of law? As the Roman saying had it: Quod licet Iovi, non licet bovi i.e. it is wise not to stray outside a safe area. Whoever likes danger can find better ways of satisfying the craving for it than in the areas of corporate finance and tax.

This is why we are bringing you coverage over various risks and perils that every tax director, head of accounting or entrepreneur should be aware of. Such as carousel frauds. Do you know, for example, that the tax authorities can request you to settle an old tax debt for a business partner even though they are not on the list of unreliable VAT payers? The other articles deal with changes in the lump sum deductions for self-employed individuals and the oft underestimated risk of embezzlement of funds in companies that are not large enough to have its own internal audit department.

The good news is that each of the above threats can be eliminated or substantially mitigated if the company prepares for it sufficiently in advance. The same as a doctor, an attorney or a safety technician would recommend, also the tax advisor: it is wiser to invest into prevention than to deal with the consequences.

However, life is not just work and we have some pleasant months up ahead. The summers should be warm, Wien still hosts a fantastic exhibition of paintings featuring Monet and Picasso (to be replaced with the World of Romanticism mid-September), there is a new film by Kusturica in the cinemas starring Monica Bellucci and the Czech Republic is still a country of music festivals of all genres.

I wish you a relaxing vacation, great weather and no unexpected tax audits.

Ivana Ottová

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ONE-CROWN BONDS AS ABUSE OF LAW IN THE DOMAIN OF TAX

One-crown bonds have been frequently discussed by virtually all the media in the last couple of months. Despite that, it may not be completely clear what the underlying logic of the oft-discussed transaction is and which principles and rules it relied upon. And, last but not least, what it means for the taxpayers.

How the tax planning was done

Let's start with one-crown bonds. Based on general rules, taxable income subject to withholding tax shall be rounded down to a crown. For bonds issued until the end of 2012, the taxable income was determined for each bond individually, including cases when one investor held a package of bonds from the same issuer.

This provided an opener for tax planning consisting in one issuer issuing a package of bonds with a nominal value of one crown each. It is obvious that regardless of the interest rate, the tax shall be rounded down to zero. If an investor, for example, purchased CZK one million worth of bonds comprising one million one-crown bonds at 5% annual interest rate, the gain from each and every bond was 5 hellers only. The taxable income

after rounding down was zero so the tax was zero as well even though the total gain was CZK 50,000.

In practice, this tax planning was seldom used. However, in November 2011, the Ministry of Finance issued one-crown state bonds which was widely interpreted by the public as an acknowledgement of the fact that the use of such a ploy was acceptable and would not be challenged by the tax inspector. The following year, an Income Taxes Act amendment was enacted which determined that all the individual taxes from gains from bonds shall be added up first for each investor before rounding down the total tax to full crowns. The new rule applied to bonds issued as of 1 January 2013.

"… the Ministry of Finance issued one-crown state bonds which was widely interpreted by the public as an acknowledgement of the fact that the use of such a ploy was acceptable."

This is why one-crown bonds became an instant hit in the fall of 2012. Whereas in prior years the issuance of private bonds amounted to around CZK 10-15 billion a year, at the end of 2012, 525 cases of private bond issues totaling CZK 164 billion were registered.

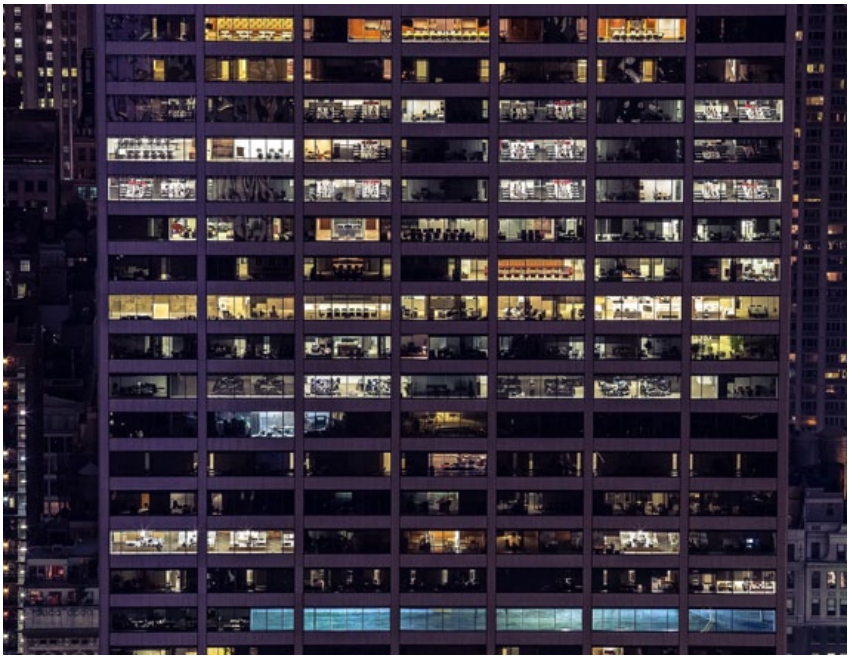
Abuse of law: formal procedure based on law is not enough

It is obvious that issuance of one-crown bonds and their subsequent purchase by an investor is in line with the formal wording of the law. However, can it be considered a legitimate tax planning instrument? This is where the abuse of law doctrine comes into play.

Abuse of law is defined as a situation where a taxpayer proceeds in accordance with the law and fulfills all formal requirements but where the resulting operation is completely against the spirit of the law and the intention of the lawgiver.

Historically, the first court decision where the abuse of law doctrine was applied concerned the civic organization named "Water-Earth-Air Club". The members of the organization were the wife and husband B., their three children, brother-in-law and son-in-law of Mr B., so all extended family. The members provided gifts to the civic organization which they deducted from their taxable income in line with the conditions laid down by the Income Taxes Act. The civic organization then used the funds to finance vacations of the family B., their sport equipment, reimbursement of travel to school as well as trips to mountains, winter camps, fit center tickets, language lessons, tuition fees, diving expeditions etc. In principle, it meant that the members of the organization financed their own private activities while claiming their value as items reducing their respective taxable income.

" The doctrine of abuse of law was quickly adopted by courts at large and currently it can be considered a common instrument of application of the tax law."



The decision of the Supreme Administrative Court issued 10 November 2005 was based on the doctrine of abuse of law. Based on the court's decision, the idea that a lawgiver would provide for deduction of gifts from taxable income in order to enable the financing of sport, educational and cultural needs of the taxpayer's own children would be absurd. The doctrine of abuse of law was quickly adopted by courts at large and currently, it can be considered a common instrument of application of the tax law. The concept of abuse of law is also found in the case law of the European Court of Justice1.

At which point does issuance of one-crown bonds represent abuse of law?

Can one-crown bonds be considered an instance of abuse of law? It depends. The following scenario can apply:

a) A company needs an additional source of financing;
b) Financing through bonds is cheaper or more beneficial than a bank loan;
c) There is a good reason why the nominal value of the individual bonds should be exactly one crown e.g. the company wants to offer the bonds to its own employees so that they can buy them in small volumes (e.g. CZK 50).

Upon fulfillment of the above conditions, it is clear that no abuse of law has taken place. The participants have taken advantage of a tax benefit which results from the workings of the law. However, there are also less clear-cut cases and at the other end of the range, one can encounter a case where

1 See e.g. decision of ECJ C-255/02 Halifax from 21 February 2005 or C-103/09 Weald Leasing.

a) It is questionable whether a company needed similar financing or not;
b) Interest rate on bonds significantly exceeds interest rates that banks would offer under normal conditions;
c) The one-crown bonds are, to a full or large extent, purchased exclusively by the company's shareholder.

These very conditions already provide enough scope for application of abuse of law to the tax inspector. The transaction in itself simply lacks any economic rationale or reason (other than to realize a tax benefit). If, in addition, it is doubtful whether the bonds were even paid for by the shareholder, it is beyond doubt that the tax inspector should deal with the issue of abuse of law.

What does the tax administration say?

The formalistic approach which the tax administration applies to the "review" of one-crown bonds is almost ridiculous. This is best evidenced by a document which was prepared at the request of the Budget Committee of the Parliament and which is available at http://www.financnisprava.cz/cs/financni-sprava/pro-media/tiskove-zpravy/2017/dopis-generalniho-reditele-martina-janec-8420

The Budget Committee requested preparation of a methodological decree for reviews of whether law was abused with issuance of one-crown bonds. The answer of the tax administration is very detailed about issues such as whether thin capitalization rules were fulfilled or whether the interest was arm's length but completely bypasses the issue of abuse of law. Instead, it simply states that no laws prevent issuance of one-crown bonds.

"The answer of the tax administration is very detailed about other issues but completely bypasses abuse of law, the one issue it was supposed to address in the first place."

In its *Document for the Budget Committee to the issue of taxation of one-crown bonds*, the General Financial Directorate goes further and in principle states that

- Corporate income tax is not impacted by the fact whether one-crown bonds were issued or not because taxable income consists of interest accruing from one-crown bond in the same manner as from a bond of any higher value. Rounding does not have any effect so that it is irrelevant what the nominal value of the individual bonds was.
- No tax avoidance at the level of personal income tax is possible, because based on the law interest income from one-crown bonds issued by the end of 2012 is not subject to tax. This procedure is in accordance with the law and its impact can thus not be considered an instance of tax avoidance.

We are of the view that the above is a classic example of how information can be manipulated and served out of context in a distorted way.

However, even the case of tax avoidance of (now a former) finance minister provides some promise. We can expect that at least until the Parliament elections that are due this fall, the tax administration will abstain from applying the abuse of law doctrine.

Ivana Ottová

CHANGES IN LUMP-SUM DEDUCTIONS

Tax return filing deadline for 2017 is still a long way off but sometimes it is important to think ahead. This time because there are two ways of claiming lump-sum deductions and it will be up to the taxpayer to choose the one they will apply.

Based on the recently approved tax amendment, it will be possible to apply lump-sum deductions up to the total amount of CZK 2 million excluding VAT i.e. the same treatment as for 2016. However, in such a case, it will not be possible to use the tax credit for spouse and children (the same rule applied for 2016 just like the condition that, when claiming lump-sum deductions, the taxable income from self-employed business activities should make up more than 50% of the total taxable income).

The second alternative assumes that tax credits for spouse and children will be claimed. Under that scenario, it will be possible to claim the lump-sum deduction only up to CZK 1 million i.e. one half compared to the first alternative.

The lump-sum deduction rates have remained the same i.e. 80% (agricultural production, crafts etc.), 60% (self-employed individuals), 40% (doctors, attorneys etc.) and 30% (lease of assets).

In practice, it is worth calculating both alternatives and choosing the more appropriate one.

Regardless of the above stated, it will be possible to claim costs actually incurred. Documents should thus be archived in real time so that a decision can be made in the weeks leading up to the tax return submission. For avoidance of doubt - when claiming actual costs incurred, it is also possible to claim tax credit for spouse and children.

„ Documents should thus be archived in real time so that a decision can be made in the weeks leading up to the tax return submission."

Martin Pecka

COVERT THREAT OF CAROUSEL FRAUDS

Electronic Records of Sales (EET), VAT Control Statement or fines for administrative errors are all too well known to the taxpayers, at least those doing business. However, treatment of the so-called carousel frauds is not discussed that often. Maybe the reason is that the impacts are less widespread. However, the number of affected companies already reaches into hundreds and contrary to, for example, VAT Control Statements, the impact can be devastating, especially in combination with the so-called securing orders.

As one of the rare articles on the topic so eloquently states: *"instead of going after the true criminals, the tax administration collects funds from entrepreneurs. From those who – often unknowingly – did business with somebody who was avoiding tax. Tax inspectors know that, contrary to the criminals, the entrepreneurs will always have the funds they are looking for".*

In practice, the situation can be that you buy goods from a vendor and you verify that they are not on the list of unreliable VAT payers. A review shows that everything is in order, you take over the goods and you pay the entire amount including VAT. However, your vendor does not pay the VAT to the tax authorities. Or, even more often, one of the vendors in the chain leading up to your transaction does not pay VAT continuously for a longer period of time. The tax authorities are facing an issue how to claim the overall tax debt that has accrued over a longer period of time.

"If the tax authorities reach a conclusion that a company did not review its vendors sufficiently and did not take adequate measures to prevent tax fraud through its (non)participation in the chain of transactions, the company is considered as being party to the whole scheme."

The tax authorities initiate a tax audit in your company as a part of which they investigate if the supplies concerned actually took place and were real as well as whether you could, as a company owner or a manager, be reasonably aware of the fact that your company was a part of a chain of transactions where VAT was intentionally not paid. If your company fails this test, it loses an input VAT deduction from the supply received. And that despite the fact that the supply of goods took place and that the company paid output VAT. If the tax authorities reach a conclusion that a company did not review its vendors sufficiently and did not take adequate measures to prevent tax fraud through its (non)participation in the chain of transactions, the company is considered as being party to the whole scheme. As a participant in a fraud, it loses all legal protection with respect to VAT, especially tax neutrality and the relating input VAT deduction.

Distress warrant, obligation to pay within three days

What follows is an assessment notice, often preceded by the so-called securing order. Securing order is an extreme instrument which serves to the tax authorities to secure potential tax debt in situations where the tax inspector has justified doubts that the taxpayer will be able, or will be willing, to pay the assessed tax themselves.

A distress warrant includes an obligation to pay the amount owed within three days and if a company is not able to do so, its bank accounts or assets (such as cars,

machinery and other equipment) are seized and the company can also be subject to a raid. The company's business activities can be severely crippled, the seizing of accounts prevents the company from fulfilling its business obligations or paying salaries to its employees and, as a result, the company often ends up in bankruptcy.

"Participation in tax fraud" thus effectively means a failure of an entrepreneur to put in place internal processes and directives providing sufficient control mechanisms."

The extent of the risk is illustrated by an example that was published by the media. *"One of my clients…carried out business with counterparties that were reliable VAT payers and the amounts were paid to their bank accounts which were published by the tax administration. In 2016, the tax inspector found out that the counterparties had not been paying VAT and could not be contacted by the client. The client received a securing order for CZK 17 million, CZK 8 million was withheld from their account, then the tax authorities carried out a raid in their establishment, took a cash register, seized the car that he been used on that very day for a commute and drew up a list of inventory. They would collect other cars and took out a pledge on the company's property."*

What is the legal basis for the tax authorities' approach? In the European Court of Justice's case law, the first practice already appeared as early as 2006, when ECJ articulated two basic principles:

- VAT payer does not have right to input VAT deduction if they participate in a tax fraud.
- Participation in a tax fraud should not be construed merely as being intentionally part of a fraud but also knowing, or **being capable of knowing** that the fraud takes places in the chain of transactions that they are part of.

"Participation in tax fraud" thus effectively means a failure of an entrepreneur to put in place internal processes and directives providing sufficient control mechanisms against becoming a part of a chain of tax frauds.

The problematic issue is that neither the tax administration nor the settled court practice have articulated which control mechanisms should be considered as adequate. Thus, we are facing a situation when there is a risk that is not very likely to crystallize but if it does, the consequences are truly devastating. How to manage such a risk?

What to focus on? First and foremost, do not carry on business with suspect parties

In some of the European countries, the tax authorities issue guidance as to which aspects of the business partners' activities to review. When all the required boxes are ticked off, the company should be safe. In the Czech Republic, nothing of the sort exists. Given the absence of any guidance as to the vendor review process, the only safe way of doing business is to enter into business with trustworthy business partners and, even then, to thoroughly review not only the business partner but also the transaction itself. Special attention should be paid to supplies for very low prices as well as to new business partners.

"The only sensible solution is not to enter into the transaction with such a business partner in the first place."

The minimum set of items that should be reviewed in case of new business partners includes the following:

- Review the vendor's track record in all publicly available registers such as the company register, insolvency register and the register of unreliable VAT payers and the review of whether financial statements have been filed in the Record of Deeds,
- Verify the identity of the vendor's representatives,
- If the business negotiations are not carried out directly with the company director, verify authorization of the representatives to act on the vendor's behalf (ideally based on a certified power of attorney),
- Verify that the place of residence of the company directors is not at a town hall,
- Verify that the vendor can be contacted with standard means (via mail, e-mail, telephone – also make sure that the contact details are published on their web page, if they have one),
- Verify that the company does not have a virtual office in the so-called office house or at a post box.

There is no single recipe how to identify a risky business partner. If an entrepreneur identifies any signs of unusual conduct of one of the future business partners such as a very low price for goods compared to the market standard, inadequate contractual coverage of the transaction or a virtual office, it should be a red light. If other ominous signs appear such as the said place of residence of the company directors at a town hall, difficult identification of a person acting on behalf of the company or a requirement to divide payments into many small ones (so that they pass under the radar of the VAT Control Statement), the only sensible solution is not to enter into the transaction with such a business partner in the first place. The reality is that conclusion of a seemingly great deal can become truly devastating soon afterwards.

Ivana Ottová

SO THERE IS NO RISK OF EMBEZZLEMENT IN YOUR COMPANY? WE HAVE HEARD THIS FROM ALL THE VICTIMS

Practice shows that standard control mechanisms cannot prevent a sly, highly motivated accountant to find a channel through which to siphon off millions or even tens of millions of funds. A larger organization deals with the risk through internal audit departments, smaller ones need to find a functioning solution at an acceptable cost.

An accountant embezzled CZK 3 million from a company in the Beroun region. Another accountant embezzled CZK 3.4m from a village in the Rýmařov region. A company in the region of Zlín lost CZK 15m over the period of 11 years. A plant in the Karlovarsko region misses CZK 2.5m of funds. However, the most interesting case took place in Kuřim where an accountant fell for a scammer on a dating website and transferred to him CZK 110m from a company account despite the fact that all the transactions in the company were subject to the four-eyes principle and approved by the line manager.

However, such cases of news that we can read by tens and hundreds only account for a tip of the iceberg. Many other cases have not reached the media because the investigation is still under way, embezzlement has not yet been identified or the company owner is embarrassed to admit that somebody stole from him and is seeking an out-of-court settlement.

Four-eyes principle is not enough

There is no consolation in the fact that the accounting department was chaotic or amateurish, the dishonest accountant had too high an authorization or that they were not subject to controls. In most of the affected organizations, control mechanisms were at a level which is usually considered as adequate. They may not have been followed too zealously but that is also a part of company routine, especially when people trust each other. This shows that a perpetrator who is motivated by a potential gain exceeding his annual salary many times over and who is more familiar with financial processes than anybody else in the organization (in fact, the perpetrator could have co-authored them) can put up enough effort and creativity to break through all control mechanisms.

„ In most of the affected organizations, control mechanisms were at a level which is usually considered as adequate.“

A typical example of a control mechanism which is implemented in most organizations, provides a sense of security while failing quite often (as it did in the case of the CZK 110m embezzlement in Kuřim) is the four-eyes principle, if ill-defined in terms of areas, staff or positions covered. In the final effect, this can lead to a situation where the controlling individual is not capable of reviewing every single document and starts relying on the controlled individual. Another typical case is when the four-eyes principle is only applied within a small group of people where collusion can arise.

„ The assets of the company are subject to many transactions and many of them do not even seem to be risky at first sight. “

Two main excuses why the cash register is not secured

In larger organizations, this type of issues does not happen very often. They are likely to have invested in the internal audit department or similar control functions which are independent of the accounting department handling daily transactions. However, smaller companies cannot afford to dedicate staff to internal audit and usually consider the risk to be low. The reality is different though.

‘THIS CANNOT HAPPEN TO US’ or ‘WE HAVE THINGS UNDER CONTROL’. This type of argument is easily proven wrong not just by actual cases of embezzlement where the control mechanisms failed but also by the results of preventive reviews of control mechanisms when they are eventually performed. The assets of the company are subject to many transactions, not all of them concerning accounts, and many of them do not even seem to be risky at first sight. As regards trust in people – let’s not forget that people al-

ways get into new unforeseen situations. Somebody's child may get sick, somebody's lover can get pregnant – it is difficult to judge how people will react.

'WE CANNOT AFFORD IT' is an even more naïve attitude. First, costs of not implementing any functioning control mechanisms are far greater than the costs of implementing them. The total costs of embezzlement include not only the value of the missing funds (which already tends to be high), but also a significant amount of management time (either spent on crisis management or when securing substitute funds) as well as extraordinary expenses (staff reorganization, reduction in business activities) or reputational risk (as a consequence of reduced ability of the organization to fulfill its obligations towards suppliers and vendors or even earning an undesired reputation as an incompetent or unreliable organization which could allow such things to happen).

The worst is to seek insurance when the fire is already on

Second, it is not necessary to create brand new internal audit departments. Many of the system weaknesses can be tackled with existing resources and others with minimum investment.

As elsewhere, the same rule applies here as well – the first step towards problem resolution lies in its identification. It is often the case that the initial system analysis leads to identification of a weak point which can be covered at a reasonable cost. This is where LERIKA can assist you very efficiently. Please do contact us if you are aware of weaknesses arising out of an internal information system and are willing to minimize or eliminate them. We can find a way of mitigating the risks even in cases of budget constraints.

The worst is to ignore the problem, face embezzlement as a result and only then invest in a functioning solution.

Ondřej Němec

After years, back to school

Renata Stará, a smile on her face, may have joined Lerika only weeks ago but is no novice in her profession. Doing accounting, which she does for living, fulfills her and is fun to her. While gaining experience in administration and accounting, she returned to school 11 years after the final exam to remote-study the field of accounting and finance management at SVŠE university. During the studies, she mainly coped with finance mathematics and statistics but all the effort invested has paid off.

She is happy to have joined Lerika where she acts in the capacity of a stand-alone accountant. She mainly appreciates the friendly and pleasant environment reminiscent of a family firm. "Nice people have come together here", she says, "with a professional attitude while remaining friendly and inclusive". Yet even accountants need to relax every now and then. Renata's hobbies include trekking outdoor with her husband, swimming and playing badminton and table tennis.

JOKES ABOUT ACCOUNTANTS

Why are our employees so happy?
Our computer failed and we paid them taxes instead of salaries.

A man at a doctor: *"why do you have so many bruises on your legs? I bet you are a footballer."*
„No, I am an accountant. I was at a tax authority yesterday and I was getting discreet hints from the director as to how to respond."

The accountant is complaining to a doctor about sleep issues. "How you tried counting the sheep?". "Well, that's the issue – I always make a mistake and then spend three hours trying to figure out where it was."

A fine is a form of tax levied from making mistakes, tax is a fine imposed on those who are successful.

What does an accountant's wife say when she cannot fall asleep: "Darling, tell me something about your work."

A physicist, mathematician and logician get a question: "how much is two times two?"
A physician looks at his tables, inputs the query in a computer and reports back after a while: "the result is between 3.98 and 4.02". Undisturbed, a mathematician takes a moment of concentration and then proclaims: "I do not know the solution but I am sure it exists." Logician: "Please define two times two more thoroughly." Philosopher: "What do you mean by two times two?" Finally, an accountant closes all doors and windows, looks around carefully and asks: "What do you want to result to be?"

Two students of accounting meet on their way to a lecture hall and one asks the other. "Where did you get such a nice bike?". "Well, I was walking in a park yesterday while thinking what to do in the evening, when a beautiful girl was cycling by. She slammed the bike in a ditch, took off all her clothes and told me: please take whatever you want." "You did well", says the former student. "I don't think her clothes would fit you very well."

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