

Implementation of Exit Taxation in the Czech Republic

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This article provides an overview of the exit taxation rule introduced to the Czech tax law as a result of the implementation of the Anti-Tax Avoidance Directive and discusses its related theoretical and practical aspects. For the purpose of this article, a preliminary hypothesis is proposed that the Czech exit taxation rule can effectively counteract certain tax avoidance transactions and yet remains proportionate.

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Introduction

The concept of the exit taxation, i.e., taxation of assets transfer abroad without a change of ownership, has been introduced to the Czech tax law only recently as a result of the Anti-Tax Avoidance Directive¹ (further ATAD) transposition. In the past the Czech Republic had neither the exit tax rule nor any similar measure and even the transposed exit tax rule could have been used only recently due to the transitional provisions. Therefore, there is no practical experience with the application of exit taxation which has been already

¹ Council Directive (EU) laying down rules against tax avoidance practices that directly affect the functioning of the internal market of 12 July 2016 (no. 2016/1164, as amended).

made public and there is also only limited amount of domestic scholarly writing on the topic.

Therefore, this article provides an initial overview of the exit taxation implementation in the Czech Republic and discusses related theoretical and practical issues that may surface. For the purpose of this article, a preliminary hypothesis is proposed that the Czech exit taxation rule is an effective measure counteracting certain tax avoidance transactions and yet remains proportionate.

From the range of scientific methods, this article makes use of description in order to introduce the Czech transposition, critical analysis to identify consequences of its application and synthesis to form the conclusion regarding its effectiveness and proportionality.

The Czech implementation of exit taxation

In line with art. 5 of the ATAD, sec. 23g and 38zg of the Income Taxes Act² introduces the institution of taxation of the transfer of assets without a change of ownership, i.e., so-called exit tax. The purpose of this measure is the prevention of tax avoidance by transferring assets within or by one entity from the Czech Republic to a foreign jurisdiction with lower tax burden where the assets may be potentially realised while the Czech Republic would otherwise lose the right to tax this realisation.

Comparing article 5 of the ATAD and the relevant provisions of the ITA it could be presumed that the transposition is rather minimalistic and should be, therefore, without complexities. However, more detailed analysis below suggests otherwise.

In contrast with the most provisions introduced as a result of the ATAD, the exit taxation rule is applicable for the tax periods starting on or after 1 January 2020.³ Therefore, its potential effects would be reflected only in tax returns submitted with the tax authorities on 1 March or July 2021 and there has been minimal practical experience with its application to date. However, at the beginning of 2021, the tax authorities issued a non-binding interpretative guidance on ATAD measures including exit taxation as well.⁴

Exit taxation and its triggering events

According to 23g/1 of the ITA, exit taxation applies only for corporate income tax purposes and may be triggered by the transfer of assets defined as three alternative taxable events which are discussed be-

low. Furthermore, it should be pointed out that if one of these events occurs, the transfer of assets would be considered as the sale of the asset to oneself at a price which would have been agreed between unrelated persons in an ordinary course of business under the same or similar conditions.

The first of these events defined in sec. 23g/2/a of the ITA is a reassignment of assets from a head office of a Czech resident corporate taxpayer to its permanent establishment located abroad if the exemption method were to be used to eliminate double taxation of the income derived from the subsequent transfer of this asset. Upon comparing the above with art. 5/1(a) of the ATAD, it seems to be clear that the Czech transposition uses a similar condition based on the exemption method while the ATAD uses the loss of the right to tax. However, it could be reasonably argued that even when the exemption method is applied, the Czech Republic, i.e., the state of the head office, does not formally lose the right to tax, it is merely contractually bound by the respective double tax treaty not to exercise this right (Pelc, 2021). As a result, there is a rather theoretical question whether this part of the Czech transposition does not interfere illegitimately with the international obligation the Czech Republic has under double tax treaties to apply the exemption method (Boháč, Hrdlička, 2018) and how this conflict would be settled by practice and courts. In addition, if no double tax treaty is concluded with the state of the permanent establishment, the income from the subsequent transfer of assets from the abroad permanent establishment would be included in the head office's standard tax base and exit taxation would thus not apply. Regardless of this fact, it could be reasonably assumed that this part of the exit transposition should not cause controversy as the reallocation of assets to abroad permanent establishments from the Czech head offices is relatively infrequent and the Czech Republic has concluded only a relatively limited number of double tax treaties using the exemption method, e.g., with Italy, Germany, Greece, Spain, Sweden, or the United Kingdom (Bureš, 2019).

The second type of taxable events is defined as a transfer of assets from the Czech permanent es-

² Act no. 589/1992 Coll., Income Taxes Act, as further amended (further ITA).

³ As per transposing act no. 80/2019 Coll., the anti-tax avoidance provisions are in effect for tax periods starting on or after 1 April 2019 with two exemptions, i.e., exit taxation and hybrid mismatches rules.

⁴ Information of the General Financial Directorate from 19 January 2021 (no. 54816/20/7100-40113-207118).

establishment abroad to another permanent establishment or to the head office if the subsequent transfer of assets were not subject to the tax in the Czech Republic. While sec. 23g/2/b of the ITA may seem almost verbatim transposition of art. 5/1/(b) of the ATAD, it should be pointed out that according to the Czech commercial law a business is considered a collective asset, therefore, this provision implicitly transposes also art. 5/1/(d) of the ATAD.⁵

Finally, the third taxable event is defined as a transfer of assets related to a transfer of residence of the Czech taxpayer abroad if the subsequent transfer of assets was not subject to tax in the Czech Republic. In this aspect the respective provision of sec. 23g/2/c of the ITA is in practice verbatim transposition of art. 5/1/(c) of the ATAD. However, it should be noted that the situation can be rather complicated if a permanent establishment remains in the Czech Republic. In this case, it would be essential to analyse the functional and risk profile of the establishment and to assess whether the assets were transferred abroad in administrative evidence, e.g., for accounting purposes, or in fact remained in the Czech Republic. In this regard it should be pointed out that the notion of assets is interpreted broadly and also includes items not recorded in accounting or in off-balance sheet accounts in accordance with the Czech Accounting Standards, e.g., certain intangible assets. Additionally, the abovementioned tax authorities' non-binding interpretative guidance on the ATAD puts forth that even transfers realised in the course of contributions or cross-border conversions are subject to exit taxation in case of no change of ownership.

Exceptions from exit taxation

In line with art. 5/7 of the ATAD, sec. 23g/3 and 4 of the ITA provide for exceptions from exit taxation

⁵ See the commentary to sec. 501 and 502 of the Civil Code in P. Lavický et al. (2014). *Občanský zákoník I. Obecná část (§ 1–654)* (Civil Code I. General provisions (§ 1–654)). C.H. Beck: Prague.

in the case of transfers of assets related to financing of securities, to assets posted as collateral, to comply with capital adequacy requirements or for the purpose of liquidity management prescribed by the law. In these cases, exit taxation does not apply if it can be reasonably presumed that the assets will be transferred back to the Czech Republic within 12 months. In addition, the transposition explicitly states that if the assets are not transferred back to the Czech Republic, the taxable event would be deemed to have occurred in the last taxable period the condition of return could have been met. This clarification mitigates legal uncertainty as to whether the exit tax should not have been imposed in the tax period of the actual transfer from the Czech Republic.

Value of the transferred assets for tax purposes

While art. 5/5 of the ATAD stipulates the value established for the purposes of exit taxation by the Member State from which the assets were transferred will be used as an input value for tax purposes in the destination Member State unless this value reflects the market value, the transposition in sec. 23g/5 of the ITA seemingly simplifies the matter by using the market value straightaway. However, the fair market value determination can considerably differ between two Member States and this provision could thus cause more potential disputes than prevent. Moreover, this presumably reasonable amendment may lead to a reverse in the burden of proof. While under the ATAD default set-up, the taken-over input value would *prima facie* suffice unless challenged and substantiated by the tax authorities, under the Czech transposition the burden of proof might directly rest with the taxpayer who would be primarily obliged to prove that the input price is in line with the market value of the asset.

In addition, it should be pointed out that this provision will be used only if the transfer is subject to exit tax in the transferring Member State. That means that even if the transfer was subject

to exit tax in a third state, the input price would be established by standard rules of the ITA for determination of the input value (Kapoun, 2019). In this case the respective depreciation charges, provisions, etc., applied in the transferring third country would be considered in the Czech Republic, which might result in an unequal treatment.

Therefore, apart from the Czech step-up mechanism being even more problematic than the incomplete solution proposed by the ATAD, the unequal treatment in relation to the third states may raise the question as to the compatibility of the Czech exit taxation rules with the ability-to-pay principle and whether the provisions do not contravene the primary EU law, specifically free movement of capital (Haslehner, 2020; Pinetz, Schaffer, 2014).

Exit taxation deferrals

Corresponding to art. 5/2, 3 and 4 of the ATAD, sec. 38zg of the ITA provides for an alternative to paying exit taxation at once within the standard corporate income tax return, i.e., to request spreading the payment of the tax obligation part related to exit tax into instalments for a maximum of 5 years. This approach apparently does not differentiate between the establishment of the amount of tax and its recovery. Thus, no deferral of taxation to the moment of the actual realisation as in the National Grid Indus case law is possible (Letizia, 2020).

It should be noted that this alternative is available only to the transfer of assets to another Member State or State of the European Economic Area which concluded with the Czech Republic or the European Union an agreement on mutual assistance in the recovery of tax claims. Therefore, the exit taxation deferral is not as such available in respect to the transfer of assets to other third countries regardless of whether there is a corresponding agreement on mutual assistance in place. It could be reasonably argued that this approach goes far beyond what can be deemed proportionate from the perspective of free movement

of capital, regardless of whether it is in line with the ATAD (Peeters, 2017). Theoretically, this stringent approach could be mitigated to some extent if the tax authorities were inclined to grant standard tax deferrals codified in the Tax Procedural Code in these situations. However, it should be noted that standard deferrals do not have to be granted and the tax authorities may set conditions of their choosing, as opposed to exit tax deferrals which are strictly regulated.

In addition, the tax authorities may subject the exit tax deferral to provision of an adequate form of security if they consider there is a risk that that part of the tax will not be paid. It could be argued that the administrative discretion is in this regard perhaps too broad (Spindler-Simander, Wohrer, 2018; Potgens et al., 2016), contravening both the domestic and EU principle of legal certainty (as discussed in para. 90 of the judgment of the ECJ of 12 July 2001, C-157/99, *Smits en Peerbooms*), and this provision should thus be interpreted in the light of the ATAD's '*demonstrable and actual risk of non-recovery*' and the relevant primary law to prevent excessive application of the guarantee. It can be assumed that if the taxpayer does not qualify for the exit tax deferral, a standard deferral if granted at all would be almost certainly subject to the security condition. Furthermore, the Czech implementation of exit taxation uses the option to impose an interest on the deferred amount of the tax, which corresponds to half of the standard late-payment interest of 8% + 2-week re-purchase Czech National Bank rate.

As prescribed by art. 5/4 of the ATAD, the deferral would be discontinued and the tax immediately recoverable if the asset were disposed of or transferred to another state according to sec. 38zg/4 of the ITA. In addition, the deferral would also be discontinued in the case of liquidation and bankruptcy, as provided by standard rules on deferrals in sec. 157 of the Tax Procedural Code. However, sec. 38zg/3/a of the ITA deviates from the ATAD when it states that the deferral will be discontinued if a taxpayer does not comply with a due date of any individual instalment. Although this provision is in line with the domestic practice concern-

ing deferrals, it is undoubtedly more stringent than the rule contained in the ATAD which allows for correction within a reasonable period of time not exceeding 12 months. While the local lawmakers, or rather the Ministry of Finance that drafted the transposing act, reasoned that under art. 3 the ATAD provides only for minimum standard of protection and more stringent rules can be adopted, it could be reasonably argued that the immediate discontinuance goes far beyond what is proportionate and, therefore, contravenes the primary law (Haslehner, 2020; Kananoja, 2020).

Effectiveness and proportionality of the implementation

As to the effectiveness of the exit taxation transposition, it should be noted that there is no available data on the extent of transfers of assets without change of ownership being used for tax avoidance purposes in the Czech Republic. Regardless of this fact and based on the discussion above, it can be expected that certain taxable events would be used quite infrequently, while the impact of the others may be relatively considerable in the near future. From the short-term perspective, a rise in the eminence of exit taxation may be caused by the current (post)pandemic situation and the related increase in insolvencies due to the governments gradually withdrawing supportive measures aimed to stabilise economies. The subsequent rise in global and intra-EU consolidation which can be reasonably anticipated may encourage the foreign groups to withdraw from local markets and to seek the most tax efficient method thereof. As the Czech Republic applies the credit method in almost all of its double tax treaties, it can be assumed that the reassignment of assets from the Czech head office to a foreign permanent establishment would trigger exit taxation rather infrequently. Conversely, the transfer of assets from the Czech permanent establishment abroad does not rely on similar conditions and such establishments are relatively standard in certain industries,

e.g., banking. Therefore, one could reasonably argue that exit taxation would apply more frequently based on this taxable event if actors in certain sectors were withdrawing from the Czech Republic. In addition, one could expect that also transfers of residence used as part of global restructuring operations would increase with the rise of insolvencies as a consequence. As a result of exit taxation targeting this event as well, taxpayers are denied the opportunity to minimise their tax liability by similar transactions and would most probably opt for one of the more traditional transfers with a change of ownership.

Conclusion

To summarise, in the author's view the exit taxation transposition complements other anti-tax avoidance provisions and assists preventing illegitimate transactions that may be used in near future.

However, a question arises whether the implementation of exit taxation is proportionate or whether the respective rules go beyond what is necessary to achieve the prevention of tax avoidance. It has been put forth in this article that certain aspects of the transposition might indeed be disproportionate, specifically regarding third country situations. In these cases, it could be reasonably argued that denying deferral of the exit tax payment, even if the agreement on mutual assistance is in place and a security can be provided, might infringe primary law, specifically free movement in capital. It would be advisable for the tax authorities to grant standard deferrals in these instances according to the provisions of the Tax Procedural Code. Similarly, immediate discontinuance of deferrals in the case of minor incompliances with the due dates of the exit tax instalments goes farther than the ATAD and may be also deemed to go beyond what is necessary and challenged before both domestic courts and the EU Court of Justice. Considering the above, the hypothesis can be considered only partly verified and lawmakers should strongly consider mitigating the problematic aspects mentioned above.

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