I. The Meaning of Avoidance and Aggressive Tax Planning and the BEPS Initiative

1) The Meaning of Tax Avoidance in National Legal Systems

The legal definition of tax avoidance is not mentioned in the Czech legal system. Even though this fact, tax administrators apply the general concept of tax avoidance (abuse of law doctrine). The Czech tax judiciary has used the term of tax avoidance since 2005, when the Supreme Administrative Court defined the tax avoidance as following: “Abuse of law is a situation when someone carries out a subjective right to unjustified harm of someone else or society; such behaviour, through which illegality is achieved, is only seemingly allowed…”. Two years later, the Constitutional Court stated to the abuse of law following: “Abuse of law (abusus iuris) is a behaviour seemingly allowed, which is intended to achieve the result of illegal; the specific case of abuse of law is a vexatious behaviour, which lies in the fact that someone has exercised his right with the intent to cause disproportionate harm to another one. The behaviour seemingly allowed comes from the objective law does not know the behaviour legal and at the same time illegal; the principle of lex specialis derogat generali shows that the prohibition of abuse of law is stronger than what is allowed by law…” In the area of tax law, tax avoidance can be considered as an action of taxpayers who are making steps in order to reduce their tax liability in a way that is not inconsistent with linguistic interpretation of legal norms, but it inconsistent with the purpose of the legislation.

In the Czech case law, the abuse of law doctrine was firstly applied in case of the deduction of gifts based on Art. 15(8) of the Income Tax Law No. 586/1992 (hereinafter ITL), when taxpayer usually establishes the Civic Association to whom the gift was granted and which was consequently used as a deductible item in the tax return. This behaviour was considered by judge as an abuse of law regardless of the fact whether the taxpayer uses benefits received by the gift or not. Other case law concerning the abuse of law doctrine was further related to the value added tax and tax code.

In respect of the ECJ case law on abuse of law, the Supreme Administrative Court and Constitutional Court like as the ECJ take into account “two limb tests”. Through this test is examined whether the law was abused. It means that the main purpose of the transactions concerned is to obtain a tax advantage which is inconsistent with the purpose of the legislation. However, contrary to the ECJ, Supreme Administrative Court is considering a fair ordering of social relationships and examining a question,

---

1 Case law, Supreme Administrative Court, No. 1 Afs 107/2004-48 on 10th November 2015.
2 Case law, Constitutional Court, No. III. ÚS 374/06 on 31th October 2007.
4 For example, the Supreme Administrative Court no. 2 Afs 7/2007-101, no. 1 Afs 10/2012-38, no. 1 Afs 107/2004-48.
5 For example, the Supreme Administrative Court no. 8 Aps 2/2007-6, no. 1 Afs 50/2007-06, no. 2 Afs 101/2007-49, no. 8 Aps 2/2007-61.
6 For example, the Supreme Administrative Court, no. 2 Afs 178/2005-64 which defines the main purpose of transaction and uses the tests on tax abuse, particularly from Helifax case.
whether taxpayer caused unjustified harm to someone else or society through the abuse of law. Thus the basic elements of the abuse of law are the purpose of the transaction and the consequence of behaviour.

The Czech Republic uses a general anti-abuse rules (hereinafter GAAR) in the form of the substance-over-form, abuse of law doctrine, the qualification of a legal act as absolutely invalid and as a reduction of the tax liability in another way. Except of GAAR, there are set out transfer pricing rules and thin capitalization rules in the ITL as a specific anti-abuse rules. Moreover, the Czech Republic uses anti-abuse rules in its tax treaties.

As was mentioned above, the abuse of law doctrine was developed through the case law. However, professional community does not take a unified view on this issue, whether is better to exactly state its definition into the ITL or Tax Code, or not. Notwithstanding, one opinion prevails, that omitting of the abuse of law doctrine in law should leave its flexibility used in case-to-case, which would not be received if the legal provision would exist. This opinion is not being changed in the BEPS Era.

2) The Meaning of Tax Planning, Abusive Tax Planning and Aggressive Tax Planning in National Legal

The distinction between tax avoidance and tax planning seems to be more difficult to determine as both of them involve tax reduction provisions that may comply with the law. Moreover, tax planning is possible to determine as compliant behaviour, while tax avoidance represents behaviour in the grey area. Generally, if tax planning goes beyond an acceptable level and may fall in the area of tax avoidance, then it is considered as aggressive tax planning.

However, similarly as in the previous case (the definition of the tax avoidance, abuse of law), the meanings of tax planning, abusive tax planning and aggressive tax planning are not mentioned in the Czech legal system. The Czech Republic does not distinguish between tax planning, abusive tax planning or aggressive tax planning. Generally all of it is considered as a planning and if the behaviour of taxpayer falls beyond the wording of the tax law, then it is classified as tax evasion.

The Czech Republic uses general anti-abuse rules (i.e. substance-over-form, abuse of law doctrine, the qualification of a legal act as absolutely invalid and as a reduction of the

---

7 The Supreme Administrative Court, no. 2 Afs 173/2005-69.
8 Namely, general anti abuse provision, limit of benefits, arm’s length principle and others in the form of general principles/rules.
tax liability in another way) and specific anti-abuse rules (i.e. transfer pricing rules and thin capitalization rule) in the domestic legal framework. Further, the Czech Republic uses anti-abuse rules in its tax treaties. However, BEPS had not any repercussion in the above mentioned meanings, the Czech Republic will not plan to introduce those concepts into its legislation.

II. The Reaction to Avoidance and Aggressive Tax Planning in the BEPS Context

1. Domestic General Anti-Avoidance Rules (GAARs)

The Czech Republic uses a general anti-avoidance rule in the form of the substance-over-form rule which is mentioned in Art. 38(3) of the Tax Code No. 280/2009 for all taxes indicated in the Czech tax law from the beginning of existence of the Czech Republic. However, its current linguistic form is the result of interpretation disputes led by the Czech courts during several years. Currently, this substance-over-form provision entitles the tax authorities to look through any transaction and assess tax according to the real substance of the transaction which is relevant for tax administration.

Moreover, the Czech tax administrations can use other provisions, namely (i) the abuse of law doctrine mentioned in case law and in Art. 8 of the new Civil Code\textsuperscript{13}, based on it the obvious abuse of law does not enjoy legal protection, (ii) the qualification of a legal act as absolutely invalid (Art. 580 of the Civil Code) provided that the legal act is contrary to the principles of morality or to the law (if the meaning and purpose of the law requires it), or if it should be filled with something impossible, and finally the qualification of a legal act as a reduction of the tax liability in another way based on Art. 23 (10) of the ITL, which is considered as a principle of abuse of laws according to the decision of the Supreme Administrative Court\textsuperscript{14}.

The Czech Republic does not see the added value of introducing or revising its GAAR on the basis of the 2012 EC Recommendation C-(2012) 8806 of 6 December 2012, as the current GAAR works well and very similar in effect to the GAAR proposed in the EC Recommendation. Therefore, there is not expected the introduction or revision of GAAR in the Czech Republic during the near future.

2. EC Recommendation C-(2012) 8806 of 6 December 2012 and subject-to-tax rule

The Czech Republic as an EU Member State considers the EC Recommendation (8806) proposing a subject-to-tax rule aimed to deal with double non taxation, as follows:

“3.2. Member States are encouraged to include an appropriate clause in their double tax convention (“DTC”)...it could read as follows: ‘Where this DTC provides that an item of income shall be taxable only in one of the Contracting State (“CS”), the other CS shall be precluded from taxing such item if this item is subject to tax in the first CS."

3.3. Where, with a view to avoid double taxation through unilateral national rules, Member States provide for a tax exemption in regard to a given item of income sourced

\textsuperscript{13}Act. No. 89/2012 of Coll.

\textsuperscript{14}Decision No. 1 Afs 35/2007-108.
in another jurisdiction, in which the item is not subject to tax, Member States are encouraged to ensure that the item is taxed.

3.4....an item of income should be considered to be subject to tax where it is treated as taxable by the jurisdiction concerned and is not exempt from tax, nor benefits from a full tax credit or zero-rate taxation.”

From the tax treaty point of view, the subject to tax rule is generally set out in all Czech tax treaties, specifically in the context of person to whom the tax treaty is applied, i.e. the resident of one or both of the Contracting states. Currently, this rule is also used in relation with the exemption method resulting into the double non-taxation provided that the subject-to-tax rule is not applied. Of course, this situation is contrary to the intended purpose of the tax treaty.

The Czech Republic uses the credits methods for the elimination of double taxation or double non-taxation in almost of all its tax treaties. It means whether the foreign income is not taxed in the state of source, then the whole income is subject to tax in the state of resident (i.e. in the Czech Republic) without results of double-non taxation. Further, in case that the foreign income is taxed in the state of source, then the Czech Republic grants the deduction of the amount equal to the tax paid (as a maximum amount) in the state of source from the amount of tax computed on such a base. Moreover, the tax paid in the source state must be proved to the Czech tax authority, otherwise the credit method cannot be applied. Therefore the risk of double non-taxation is at a minimal level in the Czech tax treaties, as only the oldest tax treaties include exemption method with the risk of double non-taxation. In those cases the Ministry of Finance welcomes the subject-to-tax rule that eliminates the double non-taxation and will try to include it during the negotiation of the new form of tax treaties which shall be updated.

III. Transfer Pricing Rules, GAARs, Specific Anti-Avoidance Rules (SAARs) and Linking Rules

Transfer Pricing Rules

The Czech Republic has used transfer pricing rules in the form of the arm’s length principle since 1. January 1993, when the ITL containing the transfer pricing provisions for related parties in Art. 23(7) entered into force. Transfer pricing rules are stipulated both for cross-border transactions between related parties and domestic transactions between related parties situated in the Czech Republic without any exception. By this way, any price resulting in the non-compliance of the arm’s length principle by the related persons is affected by this provision, i.e. if the agreed price is different from the fair market price and this difference is not satisfactorily explained, then the tax base of the taxpayer is adjusted by the ascertained difference.

Except of the transfer pricing provision in Art. 23(7) of the ITL, there is also set out a similar provision for the permanent establishment in Art. 23(11) which 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 i.e. tax base shall not be lower (or the tax loss higher) that the tax base (or the tax loss) of a resident taxpayer
performing under similar conditions the same or similar activities. Moreover, the provisions set out the methods for the determination of the tax base.

The ITL does not contain any provisions related to the transfer pricing methods or the preparation of transfer pricing documentation. For this purpose, the Ministry of Finance and the General Financial Directorate issued guidelines concerning the interpretation and application of the transfer pricing rules mentioned in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD TP Guidelines). Currently, there are four guidelines in force:

- Decree D-332 on the Communication by the Ministry of Finance in respect of international standards application in taxation of transactions between associated enterprises – transfer pricing. The decree covered the basic principles of transfer pricing, such as arm’s length principle, transfer pricing methods, comparability analysis, the relevance of the OECD TP Guidelines and Tax Treaties.
- Decree D-333 on the Communication by the Ministry of Finance in respect of §38nc of Act no. 586/1992 Coll., on income taxes – binding consideration over the transfer pricing policy used in related party transactions.
- Decree D-334 on the Communication by the Ministry of Finance in respect of the scope of transfer pricing documentation.
- Decree D-10 on the Low Value Adding Intra-Group Services which clarifies that cost plus margin in the range of 3% up to 7% is arm’s length provided that it is applied for low value adding intra-group services fulfilling criteria set out in the decree.

The Czech tax administrations is fully aware of the complexity of transfer pricing and therefore the binding consideration over the transfer pricing policy used in related party transaction can be requested from the tax authorities for the fee in the amount of CZK 10,000. This tool can be considered as the unilateral advance pricing agreement (hereinafter APA). Moreover, the Czech tax administrations also offer bilateral or multilateral APAs. However, it is not possible to appeal against a decision issued by the tax administrations.

The transfer pricing documentation is not mandatory in the Czech Republic. Notwithstanding, there is indirect obligation to prepare it, based on the Art. 92(3) and Art. 97(2) of the Tax Code Law\(^\text{15}\), i.e. taxpayer shall be able to substantiate all facts resulting from its tax return and its tax positions. Therefore the transfer pricing documentation is deemed to be part of the taxpayer’s general administration and is usually requested during the tax audit. Moreover, since 2015 the Czech tax administrations set out a new obligation in the form of reporting of the related parties and their related-party transactions (e.g. transaction of tangible and intangible property, services, interest, royalties and goods) when filing a tax return. Only taxpayers whose financial statements are subjected to a statutory audit are obliged to disclose this new report. The new received information can be used to identify taxpayers for a potential tax audit in the area of corporate taxation and thus in transfer pricing too.

The transfer pricing documentation and APAs are becoming more frequently used in the Czech Republic as a result of the specialized tax office for large taxpayers and stronger

\(^{15}\) Act No. 280/2009 of Coll.
focus of the Czech tax administrations on transfer pricing issues. Moreover, APAs and transfer pricing documentation are suitable tools for the elimination of transfer pricing disputes which arise mainly due to the fact that only definition of the arm’s length principle and related parties together with binding consideration over the transfer pricing policy used in related party transaction are set out in ITL and other transfer pricing rules and principles are mentioned in decrees with references to the OECD TP Guidelines.

From the view of the burden of proof – the Supreme Administrative Court (Decision No. 7 Afs 74/2010-81 of 27 January 2011) states that the burden of proof is generally lies on the taxpayer, however, in case of transfer pricing the tax authorities have to demonstrate that the price agreed between related parties differ from the prices that would have been agreed by independent parties in substantially similar circumstances, i.e. non-compliance with the arm’s length principle. The claim of the taxpayer cannot be only impugned.

However, is important to highlight that by the submitting of supplementary tax return previous statements in tax return are denied. In this case, the burden of proof in transfer pricing disputes again rests with taxpayer based on the decision of the Supreme Administrative Court (No. 1 Afs 99/2012-52 of 13 March 2013). The similar statement can be found in case No. 7 Afs 94/2012-74 on the investment incentives including tax relief. In this case, the compliance with the arm’s length principle is a necessary condition for claiming the tax relief and the taxpayer has to demonstrate that the arm’s length principle is followed.

From the view of the determination of the arm’s length price – the Supreme Administrative Court (Decision No. 7 Afs 74/2010-81 of January 2011) emphasized that the tax authorities must carefully examine whether or not the prices in controlled transactions were agreed to under the same or similar conditions, and must make appropriate adjustments if it is needed (i.e. to receive comparables). Moreover, this decision was consistent with the previous case law (e.g. No. 8 Afs 80/2007) about the determination of the arm’s length price in the form of a range and an adjustment of taxpayer’s transfer price to the endpoint of the range that is the most beneficial for the taxpayer.

Another case of Supreme Administrative Court No. 8 Afs 51/2009 states that one arm’s length price based on the one comparable company is not sufficient probative means for the determination of the arm’s length price. Moreover, tax authorities have to submit to taxpayer all information about the way of the determination of the arm’s length price so that the taxpayer received an opportunity to react and explain the difference. The obtaining space (time and material) was further emphasized in decision No. 1 Afs 101/2012. The same requirements are used in the case of a valuation report.

In respect of the valuation report, the Supreme Administrative Court in case No. 2 Afs 67/2012-40 of 11 February 2014 emphasized that the valuation report prepared for the purpose of real estate transfer tax cannot be used for the determination of the arm’s length price for income tax purpose. Further, in another case No. 7 Afs 53/2010 the court states, that tax authorities are not entitled to decide which of two valuation reports shall be used, if they include different results. They have to eliminate differences by interviews with valuation experts or by new valuation report.
LOB rules or anti-abuse provisions in the tax treaties

Except of the above transfer pricing rules, the Czech Republic applies other principles/rules with aim to protect the tax bases. The most common principles which can be found in the Czech tax treaties include the definition of resident, place of effective management and beneficial ownership. Further, the Czech Republic introduced anti-abuse provisions in the form of general anti-abuse provisions and limitation of benefits (hereinafter LOB). In the respect of LOB, the Czech tax administrations also issued Decree D-286 to tax the income of non-residents arising from sources in the Czech Republic.

However, the Czech tax administrations take the position that is better to focus on the general anti-abuse rules than only on the LOB in their tax treaties which only attempts to combat treaty shopping. Therefore the new Czech tax treaties\(^\text{16}\) or the Protocol\(^\text{17}\) amending the tax treaty include statements about limitation of benefits to any person or companies together with the statement about using domestic anti-abuse rules in the Article Limitation of benefits or Miscellaneous provisions/rules or Preventing improper use of the agreement, as follows:

“Benefits provided under this Agreement shall not be granted also to companies of either Contracting State if the purpose of the establishment of such companies was solely to obtain benefits under this Agreement that would not otherwise be available.”

“The competent authority of a Contracting State may, after consultation with the competent authority of the other Contracting State, deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the Convention according to its purpose.”

Some of the tax treaties include mixed statement of limitation of benefits to any person or companies, as follows:

“The competent authorities upon their mutual agreement, may deny the benefits of this Agreement to any person, or with respect to any transaction undertaken by such a person, if in their opinion the main purpose of the creation or existence of such a person or of the transaction undertaken by that person, was to obtain the benefits under this Agreement that would not otherwise be available.”

Moreover, almost all those tax treaties include the statement about using domestic anti-abuse rules, as follows:

“The provision of this Convention shall in no case prevent either Contracting State from the application of the provisions of its domestic laws aiming at the prevention of fiscal avoidance or evasion, in particular, but is not limited to, the provisions on thin capitalisation, transfer pricing and substance over form.”

| Tab.: Summary of limits of benefits and anti-abuse rules in the Czech tax treaties |
|-----------------------------------|-----------------|-----------------|
|                                  | In Tax treaty   | In Protocol     |

\(^\text{16}\) USA, Panama, New Zealand, Luxembourg, Jordan, Columbia, Kuwait, Bahrain, Syria, Uzbekistan, Hong Kong, Saudi Arabia, Barbados, China, Ethiopia, Armenia.

\(^\text{17}\) Cyprus, Philippine, Azerbaijan, Belgium, Switzerland.
amending the
tax treaty

<table>
<thead>
<tr>
<th>Limits of benefits</th>
<th>China, Ethiopia, Armenia, Barbados, Uzbekistan, Bahrain, Columbia, Panama, Luxembourg, USA</th>
<th>Cyprus, Belgium, Switzerland</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>To person</th>
<th>China, Ethiopia, Armenia, Barbados, Uzbekistan, Bahrain, Columbia, Panama, Luxembourg, USA</th>
<th>Cyprus, Belgium, Switzerland</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>To companies</th>
<th>China, Armenia, Saudi Arabia, Syria, Kuwait, Columbia, Jordan, USA</th>
<th>Philippine, Azerbaijan</th>
</tr>
</thead>
</table>

| Using the domestic anti-abuse rules | Hong Kong, New Zealand, Jordan, Saudi Arabia, Ethiopia, Barbados, Panama, China, Armenia, Syria, Columbia | Philippine, Azerbaijan |

Specific Anti-Avoidance Rules (SAARs) and Linking Rules

From the point of SAARs, which include CFC legislation, thin capitalization rules, anti-tax haven rules, anti-hybrid rules and earning stripping or interest barrier rules, the Czech Republic applies only thin capitalization rules as a common rule aimed against base erosion through excessive deduction of interest.

Thin capitalization rules are introduced in Art. 25(1)(w) of the ITL since 1993. The Czech Republic uses debt-to-equity safe harbour approach, which is based on a fixed debt-to-equity ratio 4:1. According to this provision, financial costs including interest and other related expenses in respect of credits and loans provided by related parties in excess of the ratio 4:1 between the aggregate value of debt and all equity of the company are not deductible for the tax purpose. The practical procedure of the thin capitalization rules is explained in Decree GFŘ-22 on a uniform procedure for the application of certain provisions of the ITL. Based on it, the thin capitalization rules also apply to financing costs with regard to credits and loan between related parties arranged through a third-party intermediary. The deduction of financing costs accrued on profit-participating credits and loans is fully disallowed. In addition, loans used for the acquisition of fixed assets and any interest-free loans are not treated as debt for thin capitalization purposes. Generally, interests agreed between related parties have to follow the arm’s length principle.

There are no other rules limiting deduction of interest or SAARs in the Czech Republic. However, the Czech Republic is going to introduce (in 2016) a linking rule for hybrid loan structures under the Parent-Subsidiary Directive. The Czech Republic prefers the option when the state of the payee is affected by the new rule and it is the simplest option from the administrative point of view.

Under the proposed linking rule, the received dividends in one of the Member States (in the Czech Republic) can be exempted under a participation exemption if it cannot be deducted from the tax base in the other Member State. This rule ensures that the companies are obliged to pay a tax from the received payments which were deducted as

---

18 The ratio for banks and insurance companies is set out 6:1.
a debt payment in the other Member State, and eliminates the erosion base through hybrid loans mismatches. The proposed linking rule will be supplemented into the provision of Art.19(2) of the ITL. Further, from the OECD point of view, this rule is considered as a primary rule. The secondary rule as a defensive rule, i.e. with aim to refuse the deduction of loans payments if this remuneration is treated as a tax-exempt profit distribution in the other Member State, has not been introduced in the Czech Republic so far.

In addition, the Czech Republic applies a restriction applicable to payments to tax haven entities in Art.36(1)(c) of the ITL, i.e. dividends paid to non-residents are subjected to withholding tax at a rate of 35 % (standard rate is in the amount of 15 %) provided that dividends derived by recipients who are not resident in another EU Member State or an EEA country, or a country with which the Czech Republic has concluded (i) a tax treaty, (ii) a TIEA, or (iii) a multilateral agreement providing for exchange of information to which both the Czech Republic and that country are a party. This withholding tax is always final.

IV. Application of GAARs, TP Rules and SAARs

In the Czech Republic, the GAARs in the form of substance-over-form provision is set out in Art. 8(3) of the Tax Code19. Transfer pricing rules in the form of the arm’s length principle, definition of related parties and APAs are directly mentioned in the ITL. However, the other rules and recommendations are set out in separate decrees issued by Ministry of Finance or by General Financial Directorate20. Thin capitalization rule and the forthcoming linking rule are set out in the ITL. Further, the practical procedure is explained in the Decree GFŘ-22 on a uniform procedure for the application of certain provisions of the ITL. Although all decrees are in position of the recommendations of the tax authority and are considered as a soft law, their implementation is required by the tax authority.

19 Act No. 280/2009 of Coll.