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BMB Newsfilter

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

The end of the summer brought a sudden cooling and the efforts to settle the relations in the government were not successful. As a result, **the government has lost its parliamentary majority since 1 September**. Slovakia has already had experience of a minority government, from 2004 to 2006, under the leadership of Mikuláš Dzurinda. It was this minority government that succeeded in the introduction of important reforms such as the flat tax rate and the simplification of the tax system. Eduard Heger's government will probably not push through the new tax reform, but despite all the turbulence, it may be able to pass important laws, several of which, including tax laws, were approved in September.

We are particularly pleased that the several-months-long **initiative of BMB Partners to modify and shift the Tax Reliability Index of taxpayers** was finalised, resulting in the IFA Regional Conference on 19 September. The following day, the thereto related amendment to the Tax Procedure Code was approved by the parliament. For more information about the conference see http://www.ifa-sr.sk/Invitation-conference-IFA-SR-2022.pdf. Details on both the timing and publication of the index are given in **TOP 4**.

A very important amendment to the Income Tax Act from **transfer pricing** perspective has also passed its first reading in the parliament. If approved by the parliament, the tax administrator will be able to **determine the profitability of an entity at the level of the median as a consequence of a tax audit**. At the same time, it is proposed that a taxpayer is obliged to increase the tax base under certain circumstances by **interest that exceeds 30 % of EBITDA**, irrespective of whether the financing comes from related parties or not and whether the related interest has been capitalised (**TOP 1**). As a partial patch on this new restriction, the EU is seeking to address the historical tax advantage of debt over equity through the proposed DEBRA Directive, which will allow, under certain conditions, notional **interest to be deducted from increases in equity for tax purposes** (**TOP 6**).

The main topic of **changes in the VAT area** will apparently be the customer's obligation to correct the deducted tax **if he has not paid for the relevant transaction and 100 days have passed since the due date of the liability** (TOP 3).

The most significant event in the field of international taxes was the conclusion of the McDonald's France transfer pricing and royalty dispute with a settlement agreement under which McDonald's France will pay €1.2 billion in taxes to the French tax authorities (**TOP 7**).

The more or less good news at the end is that **Slovakia has improved its International Tax Competitiveness Index by 3 ranks** and ended up in 11th place. According to the index, the strengths of the Slovak tax system include in particular the very low dividend tax rate for individuals (7 %) and the tax deductibility of business investments in machinery, buildings and intangible assets (**TOP 10**).

BMB Newsfilter

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald’s to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

CONTENTS IN BRIEF:

TOP 1: Planned transfer pricing changes and a new interest expense rule
TOP 2: Changed approach to taxation of permanent establishments
TOP 3: Upcoming changes in the VAT area
TOP 4: Tax Reliability Index postponed
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions
TOP 6: Proposal of the DEBRA Directive
TOP 7: McDonald’s to pay €1.25 bn tax settlement
TOP 8: More flexibility in applying reduced VAT rates
TOP 9: Progress in the fight against harmful tax practices
TOP 10: New International Tax Competitiveness Index

TOP 1: PLANNED TRANSFER PRICING CHANGES AND A NEW INTEREST EXPENSE RULE

The government's amendment to the Income Tax Act plans to introduce several significant changes **in the area of transfer pricing:**

A) Modification of the definition for identifying economically related parties. The shares of related parties are added together and if their sum exceeds 25 %, the persons or entities concerned are subsequently considered to be economically related.
B) The amendment plans to introduce a threshold for a “material controlled transaction” in the amount exceeding €10,000 per transaction and a principal amount exceeding €50,000 for a loan. Once approved, the current Guidance of the Finance Ministry on the determination of the content of documentation should also be amended. Transactions below this threshold should not be subject to mandatory adjustments of transfer prices between related parties.
C) The amendment plans to introduce the right for a corresponding adjustment of the tax base if the primary adjustment is made in a Slovak company and the counterparty is a Slovak permanent establishment.
D) The amendment also introduces a significant change, which proposes that the tax administrator **may determine the profitability of an entity at the level of the median** during a tax audit. If the taxpayer proves that, given the circumstances, an adjustment to a different value within the range of values is more appropriate, the tax base will be adjusted to that value. This provision strengthens the position of the tax administrator, that usually presents its own benchmark in problematic cases.
E) At the same time, the amendment proposes to reduce the administrative burden of taxpayers by introducing the possibility to submit transfer pricing documentation to the tax administrator in an official language other than Slovak.

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

F) With the aim to eliminate inconsistencies when issuing decisions on bilateral or multilateral APAs, the competent authorities have agreed that **it will be possible to use the agreed transfer pricing method also for tax periods prior to filing the application (roll back) and, at the same time, to issue the decision for more than 5 tax periods**.

If the amendment is approved, the described provisions will become effective on 1 January 2023. The amendment to the Income Tax Act is currently in the second reading in the parliament.

New limitation of tax deductibility of interest applicable also to non-related parties:

Further, the government's amendment to the Income Tax Act transposes the provisions of the Anti-Tax Avoidance Directive (hereafter "ATAD"), which sets out rules against tax avoidance practices. The purpose of this transposition is to limit the net interest expense of legal persons in order to prevent artificial reduction of the tax base of a legal entity through debt financing.

Until the end of 2023, the exemption under Article 11(6) of the ATAD is applicable in Slovakia, based on which the interest expense limitation applies exclusively to related parties (thin capitalisation rules under Section 21a of the Income Tax Act).

With effect from 1 January 2024, a new rule on the limitation of net interest expense is being introduced, which will have priority over the existing rule under Section 21a (thin capitalisation rules) and will also apply to non-related parties.

The provision also contains a safe harbour rule, i.e. the cap on net interest expense does not apply to taxpayers whose net interest expense **does not exceed €3 million**.

A taxpayer who is not subject to the safe harbour rule is obliged to increase the tax base by interest that exceeds **30 % of EBITDA** (earnings before interest, tax, depreciation and amortisation). In contrast to Section 21a, interest that is part of the acquisition cost or own cost of an asset (capitalised interest) is also included in net interest expense.

The taxpayer may only carry forward unclaimed net interest expense for a maximum of five consecutive tax periods, subject to the condition that the value of the deducted interest expense does not exceed 30 % of EBITDA in a given taxable year.

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

The good news is that, in addition to limiting tax optimisation, the European Union is keen to promote a reliable, efficient and fair system of corporate taxation in the EU. In an attempt to address the historical tax advantage of debt over equity, it has introduced a proposal for the DEBRA Directive under which, under certain conditions, **notional interest on increases in equity will be deductible for tax purposes.** If approved, the directive will apply from 1 January 2024, with a proposed implementation date of 31 December 2023 (more on this in TOP 6).

TOP 2: CHANGED APPROACH TO TAXATION OF PERMANENT ESTABLISHMENTS

The draft amendment to the Act No. 595/2003 Coll. on Income Tax (hereafter "ITA") also affects permanent establishments (hereafter "PE"s) and the approach to their taxation.

While the **current legal regulation** on the **calculation of the tax base of a PE that does not keep double-entry books** (Section 17(1)(d)) is based on the **cash principle** (the difference between income and expenditures), the **new wording of the act explicitly establishes also the accrual principle**. When determining the tax base, the PE should therefore be able to proceed upon the **difference between the PE's income and expenditures attributable to the PE as shown in the headquarters' accounts**. The amendment responds to the requirements of practice. It is very common for the PE's headquarters abroad to keep double-entry accounts and this is in many cases a more reliable basis for determining the PE's tax base.

In Section 17(7), the proposal also modifies the procedure for including income (revenue) and expenditures (expenses) incurred before the origination or recognised after the termination of the PE. The change will allow tax expenses to be claimed by the PE even if the condition for claiming them was met after the PE ceased to exist (e.g. expenses underlying the payment condition). The PE can claim these expenses (costs) after its termination by means of an amended tax return for either of **the last two tax periods when it still existed**.

TOP 3: UPCOMING CHANGES IN THE VAT AREA

The amendment to the Act No. 222/2004 Coll. on Value Added Tax (hereafter "VAT Act"), which was approved by the Slovak government on 25 August 2022, introduces numerous changes. It is proposed to come into force on 1 January 2023 with a small exception.

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

The proposed amendment transposes the EU Council Directive 2020/284 of 18 February 2020 amending Directive 2006/112/EC and introduces harmonised rules **to combat tax fraud in cross-border e-commerce** and to check the correctness of the amount of the VAT declared. This change is proposed to take effect from 1 January 2024.

The main topic for business entities **is the obligation of the customer to make a correction of the deducted input VAT**, which must be made on the purchased goods/services if he has not paid for the above supplies. The correction is to be made **in the tax period in which 100 days have passed since the due date of the liability**.

At the same time, the conditions for the possibility of correcting the tax base for an irrecoverable receivable have been softened, **i.e. the receivable will be considered irrecoverable if 150 days have elapsed since the due date (until now 12 months)**. Further, the lower limit for receivables that can automatically be considered irrecoverable after 150 days has been **increased from €300 incl. VAT to €1,000 incl. VAT.**

The amendment also brings simplification **in the form of deletion of the obligation of domestic registration for VAT if the subject has reached a turnover of €49,790 only from exempt activities** within the meaning of Section 37 to Section 39 of the VAT Act. This is being introduced in order to avoid the obligation to file zero VAT returns with only exempt activities reported. Entities which have already been registered and meet the conditions may apply for deregistration on these grounds.

Further, the **period for assessing late registration is being changed from 30 days to 21 days,** and the automatic obligation of the tax administrator to carry out a tax audit if an excessive VAT deduction is declared is being deleted from the law.

Originally, the draft amendment also included a limitation of VAT deduction under Section 49(7)(a) of the VAT Act. The provision was to be extended to **luxury goods and entertainment expenses**. This step was intended to be a reaction to the Amper Metal decision of the European Court of Justice as well as to the practice of tax audits. Following the comments from the Slovak Chamber of Tax Advisers regarding serious interpretation problems, the **proposed change was deleted from the amendment**.

TOP 4: TAX RELIABILITY INDEX POSTPONED

On 20 September 2022, the parliament approved an amendment to the e-Government Act, which also included an amendment to the Tax Procedure Code. The amendment brought a change in Section 165m(1) of the Tax Procedure Code, in which the deadline for publication of the list of assigned Tax Reliability Indices was postponed from 30 September 2022 to **31 January 2023.**

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

This will give the financial administration time to reassess the currently set criteria for the Tax Reliability Indices. The reassessment of the currently sent indices will be carried out as at 1 January 2023. This means that here will be no reassessment of the tax reliability index notifications already received during 2022 and the index already assigned will be valid for the whole of 2022.

TOP 5: OTHER IMPORTANT CHANGES IN LEGISLATION, INCLUDING MEAL ALLOWANCES AND MINIMUM HEALTH INSURANCE CONTRIBUTIONS

After a longer period and a turbulent political debate, the way the child tax bonus is applied changed significantly in July 2022. The child tax bonus currently amounts to **€40 or €70, depending on the age of the child**. In order to qualify, it is necessary to verify that the amount, which is calculated as a percentage of half of the partial tax base, has been met. The percentage **depends on the number of children** for which the taxpayer claims the tax bonus. It is also necessary to check whether the child receives a child boarding subsidy. In the transitional period July - December 2022, it is also possible to follow the rules in force until June 2022 for the calculation of the child tax bonus if this method is more advantageous. **From January 2023, the child tax bonus should be increased to €50 or €100, depending on the age of the child**.

In September 2022, there was another increase in meal and travel allowances. **The basic amount of the meal allowance is €6.40, i.e. the employer is obliged to contribute at least €3.52** (55 % of the amount of the meal allowance). The measure of the Ministry of Labour on the amounts of basic compensation for the use of private motor vehicles during business trips is also being amended and the amount of compensation for the use of a private motor vehicle is €0.227 per kilometre.

A proposal of the Ministry of Health has also been submitted to the government, introducing the so far absent minimum employee base for the public health insurance, which would apparently apply **not only to managing directors but also to employees working part-time.** Next year the minimum base could amount to **€98 with the minimum wage of €700 per month**. This proposal is currently being heavily criticised and it is not yet certain whether the government will submit it to parliament in this form.

Please note that the maximum assessment base for health insurance was abolished with effect from 1 January 2017. The discussion on the abolition of the maximum assessment base for social insurance (currently 7 times the average monthly wage), which was opened by the Ministry of Labour last year, met with fierce opposition and this proposal is currently not being discussed.

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

TOP 6: PROPOSAL OF THE DEBRA DIRECTIVE

The European Commission is keen to promote a reliable, efficient and fair system of corporate taxation in the EU. In order to address the tax advantage of debt over equity across the EU market, the DEBRA (Debt-Equity Bias Reduction Allowance) Directive proposal lays down rules under which, under certain conditions, **notional interest on increases in equity can be deducted** for tax purposes and the tax deductibility of the excess cost of borrowing can be limited. If approved, the directive will apply from 1 January 2024, with a proposed implementation date 31 December 2023.

The draft directive refers to all taxpayers subject to corporate income tax in one or more Member States, with the exception of financial companies. Financial companies are not covered by the directive, as some of them are subject to regulatory measures.

The proposal contains two separate measures which apply independently:

1. **Introduction of an allowance for equity ("notional interest")**
2. **Interest deductibility limitation**

Introduction of an allowance for equity

The allowance for equity will be calculated by multiplying the base (the year-on-year increase in equity) by the notional interest rate. The taxpayer will be able to claim the allowance over ten consecutive tax periods and up to the amount of the cumulative increase in the net equity for which the allowance was claimed.

The maximum amount of relief in one year should not exceed 30 % of EBITDA (earnings before interest, tax, depreciation and amortisation), which follows the rules of the ATAD guidelines (TOP 1). However, the taxpayer will be able to carry forward, without time limitation, the part of the allowance for equity not deducted in a given year due to insufficient taxable profits. At the same time, taxpayers will be allowed to carry forward for up to five years that part of the non-deductible item for equity which exceeds the maximum amount of 30 % of EBITDA in a given year.

Interest deductibility limitation

The proportional limitation will limit the deductibility of interest to 85 % of the excess cost of borrowing (interest paid minus interest received). As the rules on the interest limitation already apply in the EU under Article 4 of the ATAD, the taxpayer will apply the interest limitation under DEBRA as a first step and then calculate the interest limitation under the ATAD (in Slovak national law these are the thin capitalisation rules or additional rules for the interest limitation - see TOP 1). The above interest limitation rules will apply concurrently.

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald’s to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

The proposal for the directive will be discussed by the European Parliament and the European Economic and Social Committee. If approved, the directive will apply from 1 January 2024, with a proposed implementation date 31 December 2023.

TOP 7: MCDONALD’S TO PAY €1.25 BN TAX SETTLEMENT

On 16 June 2022, McDonald's France entered into a settlement agreement, under which it will pay €1.245 billion in taxes and penalties to the French tax authorities. **The amount made the case one of the largest transfer pricing disputes of 2022 worldwide**.

The settlement agreement was the result of an investigation by the French tax authorities into **unusually high royalties** paid by McDonald's France to McDonald's Luxembourg following a restructuring within the group in 2009. The royalties paid by McDonald's France doubled from 5 % to 10 % of the restaurant turnover. Moreover, instead of these royalties going to McDonald's headquarters in the U.S.A., they were paid to a Swiss permanent establishment located in Luxembourg, where they were not subject to taxation.

During the investigation it was discovered that McDonald's royalty payments varied significantly from one McDonald's location to another, without any justification other than tax savings for the group. This conclusion was confirmed by statements made by the managers of the subsidiaries as well as by the documentation seized, which showed that the reason for the 100 % increase in the royalty rate was mainly the higher profitability of McDonald's in France and the thereto related increase in the taxes payable.

In the course of the investigation, the French tax authorities questioned the **overall economic substance of the permanent establishment in Luxembourg holding the intellectual property** as well as the contractual set-up of the relationships within the McDonald's group.

When McDonald's received the conclusions of the investigation and was accused of tax fraud, it was offered a settlement agreement in the public interest under the French Code of Criminal Procedure. **McDonald's accepted the settlement agreement and agreed to pay back taxes and penalties totalling €1,245,624,269.**

After validating the settlement agreement and subsequently paying the taxes and public interest penalties, the administrative litigation against the undersigned companies will end.

BMB Newsfilter

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

The time limit for the right to assess tax is max. 10 years. Therefore, we recommend not underestimating the identified tax risks, consulting a tax advisor when structuring transactions and monitoring the international developments in the tax area, which will eventually be considered in Slovakia, too. Aggressive tax planning without economic substance has been overcome.

TOP 8: MORE FLEXIBILITY IN APPLYING REDUCED VAT RATES

In April 2022, EU finance ministers (ECOFIN) agreed on amendments to the EU VAT Directive to give Member States more freedom in applying reduced VAT rates, including the possibility to introduce a new VAT rate of less than 5 % for a limited number of supplies.

A reduced VAT rate of less than 5 % will be applicable to a maximum of seven out of 24 product categories. This applies mainly to basic necessities, i.e. food, water, medicines, pharmaceuticals, medical and hygiene supplies, passenger transport and some cultural products (books, newspapers and magazines). New categories have been added to these basic categories, namely internet access and live streaming of cultural and sporting events, environmental goods, personal protective equipment and personal hygiene products. All Member States currently benefiting from reduced VAT rates of less than 5 % will have to include such products in the new ceiling of 7 categories.

In addition to updating the categories, it was agreed that by 2030, the possibility for Member States to apply reduced VAT rates and exemptions to goods and services considered harmful to the environment will be abolished.

A crisis mechanism was also introduced to quickly reduce VAT rates in the event of future exceptional circumstances such as pandemics, humanitarian crises or natural disasters.

Member States must transpose the **new rules into their legislation by 1 January 2025 at the latest.**

TOP 9: PROGRESS IN THE FIGHT AGAINST HARMFUL TAX PRACTICES

In November 2021, over 135 countries and jurisdictions (including Slovakia) joined a new two-pillar plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate. These countries and jurisdictions are working on implementing 15 Actions to tackle tax avoidance, improve the coherence of international tax rules, ensure a more transparent tax environment and address the tax challenges arising from the digitalisation of the economy.

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

Since the start of the OECD/G20 BEPS Project tackling international tax avoidance, the Forum on Harmful Tax Practices has reviewed a total of 319 regimes. As at July 2022, **only one regime was marked as harmful** (free trade zones in Trinidad and Tobago) and five regimes as potentially harmful (some preferential tax regimes in Armenia and Pakistan).

TOP 10: NEW INTERNATIONAL TAX COMPETITIVENESS INDEX

Each year, the independent non-profit organisation Tax Foundation publishes the International Tax Competitiveness Index. The aim of the index is to measure the extent to which a country's tax system adheres to two important aspects of tax policy: competitiveness and neutrality. To assess whether a country's tax system is neutral and competitive, more than 40 tax policy variables are evaluated. These variables measure not only the level of tax rates, but also **how taxes are structured**. The index looks at a country's corporate taxes, personal income taxes, consumption taxes, property taxes, and the treatment of profits earned abroad. A well-structured tax code (that's both competitive and neutral) is easy for taxpayers to comply with and can promote economic development while raising sufficient revenue for a government's priorities.

According to the 2021 International Tax Competitiveness Index, **Estonia has the best tax code in the OECD for the eighth year in a row**, followed by Latvia and New Zealand. The main competitive advantage of the Estonian tax system is the fact that only distributed earnings are taxed, allowing companies to reinvest their profits tax-free. Estonian VAT system and the system of property taxes are valued very positively, too.

Slovakia ranked 11th and improved its position from 14th compared to the previous year. According to the index, the strengths of the Slovak tax system include mainly a very low personal income tax rate on dividends (7 %) and the tax treatment of business investment in machinery, buildings and intangibles. On the other hand, severe limitations in the amount of net operating losses which can be used to offset future profits only and the inability to use losses to reduce past taxable income are perceived as the main weaknesses of the Slovak tax system.

The tax systems of Italy, Poland and France are ranked as least competitive. For rankings of other OECD countries see the map below.

BMB Newsfilter

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

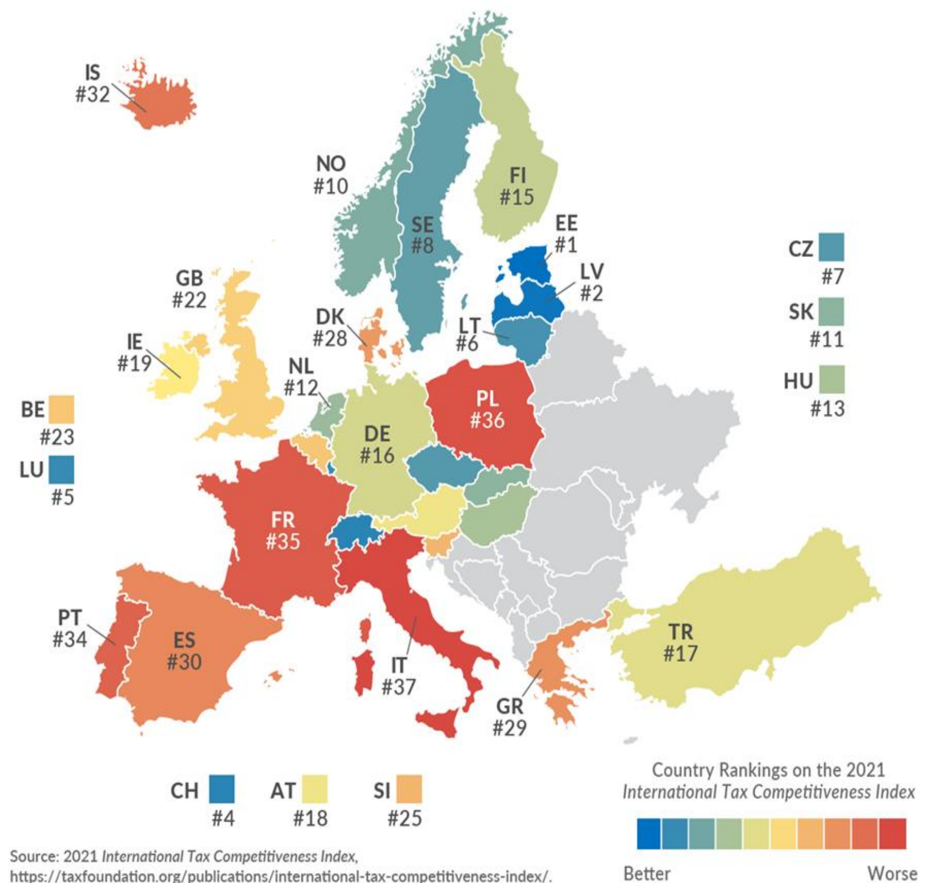
PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links



BMB Newsfilter

INDEX

PAGE 2
TOP 1: Planned transfer pricing changes and a new interest expense rule

PAGE 4
TOP 2: Changed approach to taxation of permanent establishments

TOP 3: Upcoming changes in the VAT area

PAGE 5
TOP 4: Tax Reliability Index postponed

PAGE 6
TOP 5: Other important changes in legislation, including meal allowances and minimum health insurance contributions

PAGE 7
TOP 6: Proposal of the DEBRA Directive

PAGE 8
TOP 7: McDonald's to pay €1.25 bn tax settlement

PAGE 9
TOP 8: More flexibility in applying reduced VAT rates

TOP 9: Progress in the fight against harmful tax practices

PAGE 10
TOP 10: New International Tax Competitiveness Index

PAGE 11
Useful links

USEFUL LINKS

Agenda of the Regional IFA Conference (EN)
McDonald's signed a settlement agreement (EN)
Results of reviewing preferential tax regimes (EN)
International Tax Competitiveness Index (EN)

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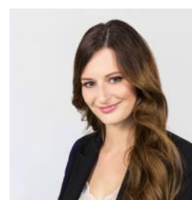
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