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B: Good faith in domestic and international tax law
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Summary and conclusions

This report summarizes the findings of the reporters regarding good faith in the Czech Republic's domestic legal system and its international tax obligations. As a monistic jurisdiction and a part of the EU, the Czech Republic is generally committed to observing its international law obligations. The concept of good faith and legitimate expectations are established in Czech law and they are also relevant to domestic tax law – under the general provisions governing the conduct of administrative proceedings, good faith of private persons must be protected by public authorities.

When it comes to the interpretation of Czech legislation, there is generally no explicit or implicit rule under Czech law that legislation should be interpreted in good faith. However, good faith can sometimes become relevant in interpreting legislation due to the applicability of EU law and of related case law of the ECJ.

While the Czech Republic is generally opposed to retroactive legislation and provides a relatively safe environment in this respect, it is on the other hand perceived (at least by Czech residents) as a country with high tax uncertainty, which can be partly due to its chaotic income tax legislation. However, the principle of *in dubio pro libertate* is recognized as relevant for tax law so in certain cases of unclarity in tax legislation, the consequences are born by the state, not by the taxpayers.

The Czech Republic recognizes the concept of abuse of rights in tax law and Czech courts have developed (based on the applicable ECJ case law) an established set of principles governing its application. In this context, good faith of the taxpayers needs to be examined in order to determine the genuineness of the transactions under review and their primary motivation (economic reasons or tax benefits). The burden of proof in the Czech Republic lies on the tax authorities, hence they need to establish reasonable doubts regarding the good faith of the taxpayer before the burden of proof shifts to the taxpayer.

Good faith can also be relevant for the administration of taxes in the Czech Republic. In case tax authorities do not use the proper form of tax audit (which can also be due to bad faith on the side of the tax authority, as the different forms give different rights and obligations to the taxpayers), the taxpayers can request protection from the courts by the means of a lawsuit against unlawful interference. Furthermore, Czech law protects legitimate expectations, which constitute a specific form of good faith or rather a product

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of good faith of the taxpayer concerning the interpretation of his tax obligations. Even though legitimate expectations generally cannot prevail over the text of the law, they can protect taxpayers against willful changes of administrative practice or breach of previous assurances.

Regarding the approach of Czech tax authorities and courts to the various interpretation issues related to double taxation treaties, the reporters have examined a number of cases without finding any direct references to good faith. Nevertheless, the report describes some prominent case law to show the general approach of the Czech Republic to the interpretation of its tax treaties. As the Czech Republic is a monistic jurisdiction, treaty overriding by means of legal regulations should be effectively impossible.

Regarding remedies invoked for breaches of good faith, the most interesting remedy invoked against the Czech Republic was a group of investment arbitration claims initiated against the state in 2013 by investors into photovoltaic power plants who argued that their investment was retroactively taxed in breach of the applicable international investment agreements. The Czech Republic has largely prevailed in these arbitrations, with the tribunals generally finding that the tax measures in dispute did not breach the legitimate expectations of the investors as to the level of the profitability of their investments. In the cases initiated under the Energy Charter Treaty (ECT), the tribunals have also examined the question of possible abuse of the ECT's tax carve-out by reducing the revenue of the investors through taxation. However, the tribunals have not addressed the question whether the Czech Republic has enacted the taxation measures in bad faith in order to avoid its international obligations.

Part One: Introduction and defining the principle of good faith

1.1. General overview of jurisdiction in the Czech Republic

The system of Czech law is historically anchored in the continental European area of civil law jurisdiction. With strong bonds to Austrian and Roman legal systems, there are hardly any connections to common law jurisdictions. Considering events in the modern history of Central and Eastern Europe, the Czech Republic has adopted a monistic approach to international law after the Velvet revolution in 1989. Especially since the accession to the EU in 2004, the Czech legal system recognizes a strong principle of priority of international law and international legal obligations before its national legal system. International treaties are incorporated into domestic law in accordance with article 10 of the Czech Constitution which states that "promulgated treaties, to the ratification of which Parliament has given its consent and by which the Czech Republic is bound, form a part of the legal order; if a treaty provides something other than that which a statute provides, the treaty shall apply."

The origin of the concept of good faith and its principal use can be found in the roots of Roman law. It is based on the Latin concept of *bona fides*. The original notion of *fides* (faithfulness, faith) preceded the contemporary principle of good faith. Cicero understood *fides* as the basis of justice. According to him, *fides* expressed certainty and constancy in promises and agreements. Acting in good faith is thus acting honestly, or at least with one

component of honest conduct. The other components are reasonableness, beneficence, and wisdom.[4]

The Czech legal system does not explicitly define good faith. However, section 6 of the Civil Code provides for honesty, which essentially corresponds to the term good faith (subjective) and thus encompasses it, and the Civil Code makes numerous references to "honest" conduct. However, the notion of good faith is elaborated in case law and in jurisprudence. Like in other European countries, Czech jurisprudence further distinguishes between objective and subjective good faith.

In its objective conception, good faith is a very broad equitable institution that expresses honest and transparent conduct. It can be defined as "a kind of general clause (rule of conduct) referring to certain general moral values, namely values generally recognised and accepted in society."[5] Good faith in this objective meaning therefore serves as a general objective criterion against which it can be assessed whether and individual acted honestly and in accordance with the morals of the society. It also implies the duty of physical and legal persons to act in accordance with its content.

The subjective good faith can be understood as a kind of psychological category. It depends on the personal perceptions of each individual whether they act in good faith or not. Some authors in the Czech Republic argue for an interconnected nature of both concepts of good faith. As explained by the Supreme Court in a case dealing with the retention (acquisition of ownership through a good faith possession): "...the fact that the possessor exercises the content of a certain right [...] in the mistaken belief that he is the subject of that is the essence of legitimate possession leading to retention. For possession to be justified, however, it is not sufficient for the possessor merely to have a subjective belief that the right belongs to him, but it is necessary that the possessor should have, in view of all the circumstances (i.e. objectively), a good faith belief that the right belongs to him, the mistake of the holder which gives rise to his belief in the existence of the right must be excusable. The mistake of the holder may be factual or legal. An error of law is excusable if the holder of the error could not have avoided it even *by exercising the usual care* that, in the circumstances of the case, may be required of anyone. Therefore, one who takes possession on the basis of one of the possible interpretations of the law cannot be regarded as an unauthorized possessor if that interpretation could have been reached by exercising ordinary care." [6] By referring to the requirement of acting with usual care, the Supreme Court appears to be leaving the realm of subjective good faith for the objective concept, under which usual care can actually be assessed. Thus, it is not only those who are aware that they are not entitled to a certain subjective right who act in bad faith, but also those who act dishonestly or negligently.[7]

4 MELZER, Filip, TÉGL, Petr. Duty to act honestly in legal affairs. *Bulletin-advokacie.* [online]. 5 December 2014. [cit. 14 November 2022]. *Available from*: http://www.bulletin-advokacie.cz/povinnost-jednat-v-pravnim-stykupoctive

5 TÉGL, Petr. Good faith in civil law. Praha, 2008. Dissertation. Univerzita Karlova. Právnická fakulta, s. 12.

6 Decision of the Supreme court of the Czech Republic from 18 March 2008, no. 28 Cdo 4833/2007.

7 BALARIN, Jan. Comments to the (absence of) principle of good faith in the draft civil code. Bulletin advokacie. 2011, č. 1, p. 28-29.

1.2. Good faith under a different name

The principle of legitimate expectations is an expression of the more general requirement of legal certainty; according to the Supreme Administrative Court (SAC), it "is closely linked to the principles of protection of legal certainty, fairness, predictability and trust in acts of public authority and the principle of prohibition of arbitrariness."[8] Thus, in some instances, this principle complements or even substitutes the general notion of good faith. The principle is most commonly invoked in relation to the binding nature of specific circumstances on the public authorities, including inter alia "the administration's settled administrative practice, settled interpretation of procedural and substantive legal rules, publicly declared policy within the limits of administrative discretion, internal interpretative or application directives, or specific and qualified assurances given by a public authority to private persons.[9]

Part Two: Good faith in domestic tax law

2.1. General overview

The principle of good faith is mainly viewed in the Czech Republic as a civil law doctrine. Nevertheless, this principle overlaps with the field of public law, including tax law. It is anchored as one of the basic maxims of "good governance" in section 3/3 of the Administrative Code, that states: "The administrative body protects the rights acquired in good faith". While the Tax Administration Act does not refer at all to this principle, the Administrative Code states in its provision § 177 that "The basic principles of the activities of administrative authorities referred to in § 2 to 8 shall apply in the exercise of public administration even in cases where a special law provides that the Administrative Code does not apply but does not itself contain a regulation corresponding to these principles." Therefore, tax authorities are obliged to take into account the fact that the taxpayer has acquired certain rights in good faith and examine the existence of good faith.

Another source of factual application of the principle of the protection of good faith in taxes is the case law of the European Court of Justice (ECJ) and subsequently also of the SAC. As noted by the SAC in relation to the concept of abuse of right, "although the prohibition of abuse of right is not explicitly enshrined in domestic law, it is a legal principle that serves as a "safety brake" in case specific rules, if applied "literally", would lead to a conflict with substantive justice, as they are used in contradiction with the essence of the law (its meaning and purpose). Similar principles are, for example, … *the protection of good faith*."[10]

8 Decision of the Supreme Administrative Court of Czech Republic from 30 March 2020, no. 1 Afs 4/2019–54.

9 Ibid.

10 Decision of the Supreme Administrative Court of the Czech Republic from 15 October 2015, no. 9 Afs 57/2015-120, para. 61.?

2.2. Good faith in the enactment of law

As was already described, the Czech legal system uses good faith mostly as a private law principle. Nevertheless, it also has its place in the field of public law and in tax law, where it is mostly relevant in connection with the system of VAT.

When it comes to the interpretation of Czech legislation, there is generally no explicit or implicit rule under Czech law that legislation should be interpreted in good faith. Czech legal theory recognizes several interpretative methods (the grammatical, historical, systematic and theological methods) but these methods are related to the examination of the will of the legislator.

However, as the Czech legal system is strongly connected to EU law, any interpretation of domestic tax legislation needs to be interpreted with a euro-compliant approach. This can sometimes lead to the inclusion of good faith as an interpretative criterion. In particular, we can refer to the judgment in *Optigen* (C-354/03, 12 January 2006), in which the ECJ stated, inter alia, that "transactions such as those at issue in the main proceedings, which are not themselves vitiated by VAT fraud, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity within the meaning of Articles 2(1), 4 and 5(1) of the Sixth Directive, where they fulfil the objective criteria on which the definitions of those terms are based, regardless of the intention of a trader other than the taxable person concerned involved in the same chain of supply and/or the possible fraudulent nature of another transaction in the chain, prior or subsequent to the transaction carried out by that taxable person, of which that taxable person had no knowledge and no means of knowledge." Therefore, even if the existence of a fraudulent VAT scheme is proven, the taxpayer included in the respective chain of traders is still entitled to deduct VAT if the taxpayer did not know and could not have known about the fraud. This rule corresponds to the fact that the rules against VAT frauds are entirely based on the case law of the ECJ and rely on the principle of prohibition of abuse of EU law. In case the taxpayer is in good faith, there is no abuse of EU law and the tax authorities should not act against the taxpayer concerned. In the cases of VAT frauds, good faith of the taxpayers is usually examined against the notion of an ordinarily careful businessman. In case the taxpayer is proven to have been aware of any circumstances which imply the possibility of a VAT fraud, the taxpayer will be obliged to present evidence that the has sufficiently responded to these facts and adequately investigated its business partners. If such an adequate response is proven by the taxpayer, he is considered as acting in good faith and cannot be held liable for VAT fraud.

The fact that ECJ case law is directly relevant to the application of the Czech VAT Act was confirmed by the SAC, inter alia, in its judgment of 9 October 2007: "the Value Added Tax Act must also be interpreted in conformity with the Sixth Council Directive. This means that the judgments of the Court of Justice of the European Communities, which deal with the interpretation of the Sixth Directive and are general to the nature of VAT as a tax, must be taken into account as an interpretative aid. In particular, the judgment of the Court of Justice of 12 January 2006, Optigen Ltd, in Joined Cases C-354/03, C-355/03 and C-484/03, and subsequently the judgment of the Court of Justice of 6 July 2006, Kittel, in Joined Cases C-439/04 and C-440/04. The Court of Justice has held that the right to deduct VAT cannot be affected by the fact that another upstream or downstream transaction in the supply chain is tainted by tax fraud of which the taxable person is unaware or cannot be aware."[11]

[11] Decision of the Supreme Administrative Court of the Czech Republic from 9 October 2007, no. 9 Afs 81/2007-60.

Another issue directly relevant to the question of good faith in the enactment of law is the issue of retroactivity. Under Czech law, true retroactivity is generally forbidden. In the case law of the Constitutional Court, this principle has been applied to tax matters on several occasions. For example in 2002, the Court repealed a part of the amendment to the Income Tax Law which expanded the range of specific cases in which the tax administrator examines transfer prices agreed between economically or personally related persons. This change was designed to be effective for the year before the amendment came into force (1997, amendment came into force on 1 January 1998). However, such retroactivity was found in breach of the prohibition of true retroactivity and legitimate trust in the law by the taxpayer and the relevant temporal provision was repealed by the Constitutional Court.[12]

Furthermore, the Czech Constitutional Court recently offered the view on false retroactivity in domestic tax legislation. The complainants sought to repeal an act which amends certain laws in the field of taxation in connection with the increase of public budget revenues on the grounds of alleged retroactivity of the contested provisions because they placed an undue increase in tax burden on the reserves of insurance companies. The Constitutional Court reiterated that it has competence in assessing the constitutionality of laws relating to taxation only insofar as to examine potential extreme disproportionality of the tax burden. The level of interference with the right of ownership must have a so called "choking effect" i.e., it must have confiscatory effects on the property of the taxpayer. The Constitutional Court held that the contested provisions are falsely retroactive, meaning that they do not create new legal relations in the past, i.e., no one becomes a tax debtor *ex post* as a result of the adoption of the provisions. The provisions merely modify for the future the legal consequences established under the previous legislation, i.e., for the tax period starting in 2020, the current amount and structure of existing reserves of insurance companies is relevant, even though they were created in the past. Therefore, the contested provisions are falsely retroactive, which is permissible provided that the change will not disproportionately affect confidence in the law. The Constitutional Court has noted the temporary significant increase in taxation and the speed and magnitude of the change. However, it stated that this alone does not necessarily constitute a choking effect and that restraint needs to be exercised in repealing tax legislation because tax policy is a matter for the government.[13]

Therefore, the Czech Republic is generally opposed to true retroactivity in tax matters and false retroactivity is subject to a proportional review by the courts. The lawmakers are aware of the implications of enacting retroactive tax measures, as evidenced by the recent discussion on the so-called windfall tax, in which the voices proposing the legislation to apply to incomes received in 2022 were not heard inter alia due to the public knowledge of the non-constitutionality of such proposal.

In the field of tax law, the individual addressees of the rules have to make a number of decisions in their activities which may have tax consequences. In all of these cases, the taxpayer must first interpret the standards himself and the tax authority will subsequently interpret them when auditing the tax declarations of the taxpayer. Therefore, the taxpayer must estimate future decisions of the tax authorities and be able to prove that its tax position is in line with the applicable legislation. It is desirable that the states provide ways to reduce this inherent uncertainty, possibly also including the criterion of good faith. Czech public

[12] Decision of the Constitutional Court of the Czech Republic from 12 March 2002, no. Pl. ÚS 33/01.

[13] Decision of the Constitutional Court of the Czech Republic from 18 May 2021, no. Pl. ÚS 87/20.

law generally recognizes the principle of *in dubio pro libertate*, meaning that in case a law limiting basic rights can be interpreted in more ways, the prevailing interpretation should be the one which interferes the least with the basic right concerned. This principle was applied e.g. in a case concerning a confusing amendment to the VAT Act which has caused some taxpayers to think that the import of certain goods was exempted from VAT. The courts have determined that the VAT Act amendment has caused significant uncertainty and that the tax authorities cannot rely on their interpretation because it is not the most beneficial one for the taxpayers.[14]

The general provisions of the Czech Tax Administration Code entitle the taxpayers to request (in cases specified by other tax legislation) an assessment by the tax administrator on the tax implications that arise from tax relevant legal facts, either those that have already occurred or those that are anticipated. Such an assessment is then binding on the tax administrator. However, the actual scope of this entitlement is limited (e.g. to transfer pricing, applicable VAT rates, applicable proportion of tax-deductible expenses etc.) and does not concern all practical issues which can come up in everyday business life. Hence, the taxpayers in the Czech Republic are often without a way to officially obtain guidance from tax authorities and they need to make decisions based on expert advice and risk analysis.

Based on the Deloitte report on tax certainty in the EMEA region,[15] which is a unique publicly available source dealing with the issue of tax certainty in the Czech Republic, 61% of respondents perceive high tax uncertainty in the Czech Republic. Respondents in the Czech Republic, similar to other European countries, agreed that the main cause of tax uncertainty is frequent changes in tax legislation and ambiguity and frequent changes in the interpretation of tax legislation by the tax authorities. Companies would truly welcome simplification of the tax system and more certainty about the future of the tax system (even more than lower taxes). It can be concluded that the Czech Republic has significant room for improvement in the area of tax certainty.

Another topic connected to good faith are the general anti-avoidance rules. The Czech Republic has transposed the EU Directive No. 1164/2016 (the Anti-Tax Avoidance Directive). In its article 6, the Directive contains a general anti-avoidance rule as follows: "For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part." This definition corresponds to older case law of EU and Czech courts. While the objective criterion is not related to good faith and concerns the purpose of the tax legislation, the subjective criterion concerns the main purpose of the arrangement under review. The interpretation of the subjective criterion inevitably includes the question whether the arrangement is a *bona fide* transaction or an artificial set of economically unnecessary actions. The burden of proof in the Czech Republic lies on the tax authorities, meaning that they need to establish reasonable doubts regarding the good faith of the taxpayer before the taxpayer is obliged to provide evidence on the genuineness of the arrangement (i.e. that the tax benefits are not the primary motivation for the chosen transaction structure). One of the prominent Czech cases dealing with abuse of

[14] Decision of the Supreme Administrative Court of the Czech Republic from 16 October 2008, no. 7 Afs 54/2006–155.

[15] Tax Certainty in the Czech Republic. Survey of Deloitte in European countries, March 2016, 5th year, available at https://www2.deloitte.com/content/dam/Deloitte/cz/Documents/survey/Danova_jistota_2015_CZ.pdf

rights related to tax matters was the assessment of tax implications of a complex corporate restructuring of the CTP group. Upon detailed examination of the complex transactional structure, the courts have held that the restructuring lacked any economically rational reasons and that it has in fact lead only to a massive indebtedness of one of the involved companies. Accordingly, the courts have confirmed that the interest resulting from the incurred debt is not tax deductible.[16]

2.3. Good faith in the administration of the tax system

Good faith can be, to a certain degree, relevant to the tax audits initiated by the tax authorities. Czech law recognizes several stages of tax audits, each with different rights of the tax authorities to request information and with a corresponding set of rights of the taxpayers. While taxpayers are formally obliged to comply with the information requests of the tax authorities, the tax authorities must choose the proper form of tax audit and cannot overstep their limits – such an approach would be unlawful. According to the SAC: "If the tax authority is in the process of checking the fulfilment of the tax obligation and the claims of the tax subject in a specific tax period and invites the tax subject to submit complete accounting and records for tax purposes for the relevant tax period, it is obliged to initiate a tax inspection pursuant to Section 85 of Act No.280/2009 Coll., the Tax Code, and cannot circumvent the institute of tax inspection by a feigned local investigation pursuant to Section 80 of the same Act."[17] Therefore, if the tax authority does not use the proper form of investigation, which can also be due to bad faith on the side of the tax authority, the taxpayers can request protection from the courts. Furthermore, in some cases, the courts have held that such improper use of lesser forms of tax audits (which, unlike the tax inspection, do not have the effect of restarting the tax time bar period) constitutes a material start of a tax inspection. As a consequence, the tax time bar period ran differently than the tax authorities thought and the use of improper form of tax audit has caused the tax authorities to lose whole cases due to the time bar rule.

Good faith, in the form of legitimate expectations, is also generally applicable to the relations between the tax authorities and taxpayers. According to the case law of the SAC, guidelines published by the tax authorities "may contribute to the formation of administrative practice (and the good faith of taxpayers). The addressees of tax obligations are in good faith that the tax administration authorities will not unreasonably and arbitrarily change their chosen approach to the interpretation of the law … It is presumed that the guidelines embody established administrative practice. If the tax authorities act contrary to those guidelines, taxpayers may invoke them."[18] On the other hand, in case of differences between the published guidelines and the tax legislation, the taxpayer is primarily bound by the law. In a case dealing with a statement of a tax authority's spokesperson, which was contradicted by the subsequent steps of the tax authorities, the SAC held that "the Supreme Administrative Court is aware of the problems that the ever-changing and letter-rich tax regulations (especially the Income Tax Act) can cause for taxpayers. In general, however, the text of the law (and possibly also administrative practice), which applies to

16 9 Afs 57/2015 – 120, op. cit. sub. 7.

17 Decision of the Supreme Administrative Court of the Czech Republic from 31 May 2017, no. 4 Afs 14/2017–36.

18 Decision of the Supreme Administrative Court of the Czech Republic from 12 February 2020, no. 10 Afs 43/2019-49.

everyone equally (without distinction of education), cannot be overridden by pointing out to an unofficial statement of the spokesperson on the website, which is also not the official website of the administrative authority she represents, and which, moreover, has not been officially presented by the administrative authority (the tax subject got the information by his own activity and it was not presented to him by the administrative authority). Such statements certainly do not contribute to objective information of the public, they may even be confusing, but on the other hand, they cannot demonstrate a long-standing and established administrative practice of the tax administration that would create legitimate expectations of the recipients of tax obligations."[19] Notwithstanding this general primacy of law over expectations based on non-legal sources, the SAC has admitted that under specific circumstances, legitimate expectations can be established even by unlawful practice of administrative authorities. However, such expectations can generally be dealt with by the administrative authorities if they provide sufficient reasons in the relevant proceedings as to why they have departed from their previous practice.[20]

Good faith is also a relevant criterion in case the taxpayer has made an error in his VAT tax declaration and wishes to correct it. Most commonly, such situations arise when the taxpayer includes an invoice into his tax declaration but the invoice is subsequently found to relate to non-existing performance. According to the case law of the SAC and the ECJ, the taxpayer is entitled to issue a corrected invoice if the taxpayer has acted in good faith or in case he has eliminated the risk of loss of tax revenue (i.e. he ensures that the other party does not use the original invoice to request a VAT refund).[21]

As noted above, Czech tax law knows the concept of a binding assessment, albeit only with a limited applicability. The assessment provided by the tax authority is binding on the tax authority *pro futuro* for a period fixed by the tax authority (up to three years), under the condition that the relevant regulations and the facts described in the request for the assessment do not change. The notion of good faith is not relevant for the validity of the assessment.

Czech law also knows the concept of Advance Pricing Agreements (APAs) as binding agreements between the tax authority and the taxpayer, valid for up to three years (if the terms and conditions and the law remain unchanged), which set out the method for determining transfer prices in related party transactions. However, the reporters are not aware of any direct relevance of good faith.

Besides the general applicability of the principle of protection of rights acquired in good faith to tax inspection proceedings and the specific cases described above, the reporters are not aware of any specific role of good faith in this context.

[19] Decision of the Supreme Administrative Court of the Czech Republic from 21 May 2021, no. 1 Afs 12/2021-35.

[20] Decision of the Supreme Administrative Court of the Czech Republic from 20 December 2013, no. 5 Afs 3/2012-131.

[21] Decision of the Supreme Administrative Court of the Czech Republic from 12 February 2021, no. 5 Afs 50/2020-43.

Part Three: Good faith in international tax law

3.1. General overview

Article 2 of the Constitution of the Czech Republic states that the Czech Republic observes its obligations under international law. These obligations include those arising out of international treaties to which Parliament has given its consent and by which the Czech Republic is bound. This means that for an international treaty to be part of the legal order, it must fulfil three conditions:

a) the international treaty must be promulgated - the promulgation in the Collection of Laws and the Collection of International Treaties is required for its validity
b) the treaty must be ratified by the President with the consent of the Parliament of the Czech Republic (both the Senate and the Chamber of Deputies).
c) the Czech Republic must be bound by this treaty – this criterion shall be primarily assessed according to the rules contained in the VCLT.

Further, if an international treaty provides otherwise than the Czech law, the international treaty applies. Thus, an international treaty fulfilling the three conditions mentioned above takes precedence in application over the law.

In international relations, good faith can be understood as a rule of interpretation and the basis of the *pacta sunt servanda* principle: "In the absence of any supranational authority, states have nothing to rely upon for the due fulfilment of international obligations but their trust in the good faith of the other parties."[22] We can also find references to good faith in the Statute of the International Court of Justice (ICJ), the UN Charter, the WTO agreements, the Vienna Convention on the Law of Treaties (VCLT) and others. Therefore, tax treaties are like all other international treaties subjected to and governed by the maxim of good faith. Furthermore, the obligation to apply and interpret the principle of good faith is a primary legal obligation for the contracting states of a double taxation agreement. It is the only element listed in article 31 of the VCLT that is independent of the ordinary meaning of the terms which can be subject to a dispute. Hence, the obligation to observe and interpret the treaty in good faith cannot be avoided by the states.[23]

3.2. Good faith in treaty interpretation

The Czech Constitutional court recognizes all basic interpretation rules of international law obligations. For example, in the ruling of the Constitutional Court, II. ÚS 305/01, 23 July 2002, it held that "according to the already mentioned Article 31 of the 1969 Vienna Convention on the Law of Treaties (Decree of the Minister of Foreign Affairs No.15/1988 Coll.), a treaty must be interpreted in good faith and in the given context, which includes, inter alia, any subsequent practice of the parties in the implementation of the treaty that

[22] Talya Ucaryilmaz, "The Principle of Good Faith in Public International Law" (2020) 68(1) Estudios de Deusto p. 53.

[23] Reflections on the Principle of 'Good Faith' as a Source of Normative Content for the Application and Interpretation of Double Taxation Convention, *available at*: https://www.dfdl.com/wpcontent/uploads/2010/09/The_Principle_of_Good_Faith_for_the_Application_and_Interpretation_of_Double_Taxation_Conventions_BTR_2003.pdf

established the agreement of the parties regarding its interpretation."[24] Or in the ruling of the Constitutional court I. US 601/04, 21.2.2007, which concerned an extradition treaty case in which the Thai complainant argued the punishment as decided by Thai courts was excessive compared to the legal order of the Czech Republic: "The Czech authorities cannot rule on the objections directed in substance against the Thai sentencing decisions since the Czech Republic would be in conflict not only with the principle of *pacta sunt servanda* but also with the principle of good faith, which are the cornerstone of international treaty law and whose importance is reinforced by the fact that they are embodied in the preamble to the UN Charter. The principle of good faith is a fundamental rule of interpretation in interpreting the text of international obligations. They must be interpreted in good faith, taking into account the whole context of the treaty and in the light of its object and purpose for which it was concluded."[25]

Regarding the approach of Czech tax authorities and courts to the various interpretation issues related to double taxation treaties, the reporters have examined a number of cases without finding any direct references to good faith. Nevertheless, some cases are summarized below to show the general approach of the Czech Republic to the interpretation of its tax treaties.

In a case dealing with the tax deduction of interest in a company with low-capitalization with a UK creditor, the SAC has examined the relationship between Czech law and the provisions of the relevant treaty. Since the treaties have primacy over domestic law and the treaties contain complex definitions of interest and dividends, the SAC concluded that there is no place to apply domestic law. Even the term "special relationship", which was relevant to the merits of the case, was not defined under Czech law and accordingly, the general *renvoi* to domestic law could not apply and the term has to be regarded as an autonomous term of international law (and interpreted according to the VCLT, possibly also using the Commentary to the OECD Model treaty). Furthermore, even in case the special relationship between the taxpayer and the creditor was established, the tax authority could not use the domestic law rules for determining the arms-length interest because such steps are not envisaged in the treaty, which contains the whole regulation of the taxation of the interest.[26] This case shows that Czech courts respect the primacy of international treaties and do not hesitate to entirely disregard domestic law (unless an express referral is contained in the treaty).

In a case decided by the SAC in 2005, the tax authority has, for the purposes of the income tax, attempted to qualify interest from loans provided to a Czech company from US and Dutch creditors as dividends instead of interest, as a consequence of which withholding tax was due in the Czech Republic (instead of tax from the interest being payable in the US and the Netherlands). The tax authority's reasoning was that the loan agreements allow the creditors to participate in the economic results of the debtor because their repayment was agreed to be made if and when the debtor would generate any profit. The tax authority has also referred to the Commentary on the OECD Model Convention on double taxation, which stated that the article on dividends deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company, i.e. when repayment depends largely on the success or otherwise of the enterprise's

[24] Decision of the Constitutional Court of the Czech Republic from 23 July 2002, no. II. ÚS 305/01.

[25] Decision of the Constitutional Court of the Czech Republic from 21 February 2007, no. I. ÚS 601/04.

[26] Decision of the Supreme Administrative Court of the Czech Republic from 28 March 2013, no. 2 Afs 71/2012-87.

business. However, the courts have noted that the applicable double taxation treaties contain clear definitions of interest and dividends which leave no room for other methods of interpretation. The SAC has also explicitly ruled out the OECD Model Convention as a subsequent agreement or subsequent practice within the meaning of article 31/3 of the VCLT, as the OECD Model Convention is by itself not a binding source of law and taxpayers cannot be obliged to assess their tax liability based on its provisions without its incorporation into the relevant treaty (however, the reporters understand that in case of any doubts with the interpretation of the relevant treaty, the SAC would consider the OECD Commentary as a complementary means of interpretation, as explained in the preceding paragraph of this report).[27] The teleological and contextual arguments of the tax authority were thus rejected in favor of a literal interpretation.

In a different case dealing with deduction of expenses on the remuneration of executive directors, the taxpayer has invoked the provisions of a Czech-Polish double taxation treaty which provided that in calculating the income of the permanent establishment, such expenses shall be "subtracted." The taxpayer argued that the provision means that the subtraction has to happen without regard to the domestic law, while the tax authority maintained that domestic law has to be taken into account (and the domestic law in this case did not allow such subtraction). The SAC held that it does not appear that the states were intending to harmonize their tax legislation through the double taxation treaty (which would effectively be the result of the argument of the taxpayer) and pointed out that the treaty is based on the OECD Model, the Commentary in which was noted that the provision in question only concerns the assignment of expenses to the permanent establishment and does not regulate the actual deductibility of such expenses, which is a matter for the domestic law.[28] Based on the Commentary, the SAC upheld the decision of the tax authority and thus preferred the purpose of the treaty and its contextual interpretation to the simple grammatical interpretation.

In a case dealing with the question of permanent establishment, the tax authorities have applied the contextual interpretation of the Czech-German double taxation treaties to determine that the taxpayer has a permanent establishment in the Czech Republic. The tax authorities have inter alia relied on the OECD Model Convention which provided a definition of permanent establishment. The SAC reproached the tax authorities for only focusing on one specific provision of the OECD Model and ignoring the following one, which (in direct relevance to the subject-matter of the proceedings) deals with the definition of an independent representative and constitutes an exception to the permanent establishment rule. As a result, the SAC has revoked the decisions of the tax authorities and returned the case for further taking of evidence.[29] The reporters note that it is unclear whether the tax authority applied the OECD Model in bad faith or merely erred in law.

Last but not least, the reporters will address the legal status of the mutual agreement procedure (MAP) between the contracting states of a double taxation agreement which, according to the case law of the SAC, is a very specific procedure which the courts need to approach with caution. Under Czech law, the taxpayers only have limited public law rights in connection to the MAP. Generally, under the double taxation agreements, taxpayers can present their double-taxation issues to the Czech tax authorities, which can reject

27 Decision of the Supreme Administrative Court of the Czech Republic from 10 February 2005, no. 2 Afs 108/2004-106.

28 Decision of the Supreme Administrative Court of the Czech Republic from 27 May 2015, no. 6 Afs 52/2015-29.

29 Decision of the Supreme Administrative Court of the Czech Republic from 25 April 2019, no. 2 Afs 103/2018-46.

them, find solutions on their own or submit them to resolution in the MAP to the other contracting state. At this stage, the courts have the jurisdiction to review the decision of the tax authorities on their next steps. However, the following stage of the MAP is a dialogue between sovereign states and the taxpayer has no rights as to its outcome. Furthermore, under the principle of the division of powers, the management of the MAP is within the sphere of the executive branch of the government. Hence, the legal review if the MAP itself is only limited to the issues of whether the taxpayer was properly informed about their outcome or of the inactivity of the state. The SAC has also explicitly noted that *de lege ferenda*, this situation could be different if the Czech Republic would include the provision of Article 25/5 of the OECD Model treaty into its treaties, because the model treaty provides that in case no solution to the dispute is found in a given time, the dispute shall be submitted to arbitration.[30] As a consequence of this case law of the SAC, it can be concluded that the taxpayers can (in case of most double taxation treaties concluded by the Czech Republic) only invoke breaches of good faith in case the state would proceed in bad faith regarding the processing of the case presented by them for resolution under the double taxation treaty, or possibly in case when the state would formally initiate the MAP but would subsequently cease being active with the intention of not concluding the MAP.

3.3. Potential treaty breaches of good faith

Given the fact that the Czech Republic is a monistic jurisdiction in which the provisions of international treaties take precedence over the domestic legislation, treaty overriding by means of legal regulations should be effectively impossible.

However, it is worth noting that in an arbitral award rendered by the international arbitration tribunal in *Antaris and Michael Göde v. the Czech Republic*, the tribunal ruled that the solar levy which was formally a tax under Czech law should not be regarded as a tax for the purpose of application of article 21 of the Energy Charter Treaty (which exempts taxation measures from the protection granted to the foreign investors by the ECT). The tribunal noted that while the solar levy was intended to raise revenue, its main purpose was to reduce the feed-in tariffs paid to the solar energy producers. The tribunal did not examine whether the Czech Republic has acted in bad faith in enacting the solar levy as a tax, it merely noted that the tax carve-out is not applicable to the subject-matter of the arbitration.[31] Hence, in this case, domestic law did not override the autonomous term *taxation measures* contained in the ECT.

Further, in a particular case dealing with the MAP, the taxpayer sought a solution to the situation in which both the Czech Republic and Germany considered him as their tax resident for a certain period of time. At the time of the commencement of the MAP, the tax was unpaid and time-barred in the Czech Republic and the German tax authorities intended to collect the tax. The taxpayer has alleged that the Czech Republic was not supporting his position due to the fact that it could not collect the tax anymore – hence, it could be said that bad faith was alleged on the side of the Czech Republic. While the SAC noted that the Czech Republic should not be dismissive of the case for such reasons, it held that the state

[30] Decision of the Supreme Administrative Court of the Czech Republic from 4 December 2020, no. 5 Afs 468/2019-71.

[31] Antaris v. Czech Republic, Final Arbitration Award, PCA Case no. 2014-01, paras 250-253.

in fact has no power to make German authorities change their mind and that it cannot act as an attorney of the taxpayer – therefore, in case Germany taxed the income, the taxpayer should primarily defend himself at the German courts.[32] As discussed above in this report, it can be concluded that any arguments based on bad faith related to the content of the MAP would most likely not be upheld by the Czech courts. In a theoretical scenario in which the double taxation treaty would expressly give the taxpayers a right to have their matters dealt with in the MAP with good faith, then the reporters are of the view that Czech courts could be more open to rule on the actual outcomes of the MAP and include the examination of the good or bad faith of the contracting states – in case the taxpayer would have a related public law right, the courts could be called upon to protect such right.

Part Four: Remedies for a breach of good faith between contracting states

4.1. General overview

Regarding the remedies invoked with regard to the potential breaches of international obligations related to taxation, the most specific remedies which concern the Czech Republic are international investment arbitrations. The Czech Republic is a party to over 60 bilateral investment treaties (BITs) and it is one of the most frequent respondent states in international investment arbitrations. While most of the arbitrations do not relate to issues of taxation, a small part of them do concern tax measures enacted by the state.

In seven parallel arbitration proceedings initiated in 2013, foreign investors have contested the so-called solar levy, a tax adopted by the Czech Republic in 2011 due to an unforeseen increase in the installed capacity of photovoltaic power plants. Due to a rigid regulatory scheme for determining green energy prices and falling costs of solar panels, the Czech Republic was not able to adjust its renewable energy support as required, which resulted into unprecedented growth of the number of new PV plants. The payments made by the state to the owners of the power plants were deemed excessive and were also regarded as being in breach of the EU state aid regulations. To address the situation, the state has inter alia introduced the solar levy, a falsely retroactive tax applicable to income from selling electricity generated in PV power plants. Under Czech law, the measure was approved by the Constitutional Court with similar reasoning as described above in this report in case Pl. ÚS 87/20 – generally, the solar levy is not unconstitutional and it would only be problematic in case it would have a choking effect on the PV plant operators, which was not proven. Similarly, six out of the seven arbitration tribunals have held in favor of the Czech Republic, while the last arbitral award on liability is not yet publicly available. Generally, the tribunals have held that the claimants could not have legitimately expected that the support scheme would not change and even if they did, the changes were such that their investments were reasonably profitable afterwards.

Another possible remedy worth mentioning are the procedures available to taxpayers based on the relatively new Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union. Effective since 1 July 2019, the

[32] 5 Afs 468/2019-71, op. cit sub. 27.

directive provides for new rules on dispute resolution of tax disputes, which should help with the effectivity of interpretation and application of tax treaties in the EU and bring enhanced legal certainty for cross-border tax disputes. So far, there has been no case law in the Czech Republic on the procedures under this Directive but its mechanisms are likely to lead to an increased number of MAPs ending with agreement between the states and, consequently, to more cases being resolved by the competent courts.

As a first option in case of a double taxation dispute, the directive provides for a MAP between the concerned EU member states. Similarly to the procedure under bilateral double taxation agreements, the competent authorities can either reject the complaint (mainly for formal reasons such as incomplete complaint or expiration of the time period for the filing), decide to resolve it on an unilateral basis or resolve it in the MAP. In case the competent authorities decide to go for the MAP, they should attempt to resolve the dispute by mutual agreement within the time period of two years (which can be extended by one year if the requesting authority provides written justification). When an agreement has been reached, the authorities notify the taxpayer – in case he accepts the agreement and waives any remedies, the outcome of the MAP is binding on the tax authorities.

If the dispute is not resolved by the MAP, the taxpayer may request the set-up of an Advisory Commission composed of the competent authorities and three independent persons drawn from a dedicated list. The Commission has to deliver its opinion in six months. The member states concerned do not have to accept the opinion and they can decide the dispute differently. However, if they don't agree together, the opinion of the Commission becomes binding on them after six months. Therefore, the function of the Advisory Commission is primarily to provide an independent assessment of the question in dispute which motivates the states to resolve the dispute, which is a welcome addition to the often slow and inflexible MAP.


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