SELECTED ASPECTS OF THE TAXATION OF FOREIGN ENTITIES IN SLOVAK TAX LAW

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In the context of the globalising economy it is becoming ever more frequent that a business entity of one state conducts its business in the territory of another state. The Slovak Republic has seen significant interest of foreign business entities following the political changes of 1989. The year 2004 has also been a historic milestone, as Slovakia became a member state of the European Union. The country's accession to the community of European countries, creating a single internal market free of barriers preventing trade and business, will certainly mean a new wave of interest among foreign entities wishing to do business in Slovakia.

Forms of foreign business in the Slovak Republic

Defining the forms of business conducted by foreign entities in the Slovak Republic has particular importance in particular in assessing the tax regime of individual types of their incomes on the basis of Act No. 595/2003 Z.z. on income tax (the Income Tax Act) and international agreements by which the Slovak Republic is bound. We can, in this regard, divide the business conducted by foreign entities in the Slovak Republic into direct business and indirect business.

Direct business means the performance of business activity (with the aim of achieving a profit) in accordance with the provisions of the Commercial Code, the Trades' Licensing Act, and other specific regulations. The Commercial Code lays down for foreign entities the same business conditions as for Slovak entities, unless legislation stipulates otherwise (for example the Foreign Exchange Act restricts the acquisition of ownership rights to agricultural land by foreign entities).

Foreign entities may conduct business in the Slovak Republic via an enterprise or its organisational part located in the territory of the Slovak Republic. An enterprise, as defined in the Commercial Code, is deemed to mean a set of material, personal and non-material components of a business. An enterprise also constitutes things, rights and other asset values. An enterprise may be created not only by a company, but also by a person.

An organisational part of an enterprise is deemed to mean a branch or other organisational unit ensuing from the enterprise's organisational structure, where this need not be located away from the enterprise's registered office. It does not have a legal personality, but forms a part of the foreign entity. This fact is of fundamental importance also from tax aspects.

Where a foreign entity conducts a business activity in the SR through its enterprise or organisational part, it is obliged to register in the Commercial Register. An organisational part of a foreign entity registered in the Commercial Register is obliged to maintain double-entry book-keeping, so that the results of its operations in Slovakia can be documented. On the basis of this it reports the economic result and submits a tax return in accordance with Slovak legislation. The tax base of the organisational part may be determined also by means of methods stated in the Income Tax Act. These methods are in accordance with the principles given in OECD recommendations.

In this regard it is necessary to draw attention to the fact that not all foreign entities present in the Slovak Republic need necessarily conduct business activity. Their presence may concern only the performance of ancillary activities related to business. Examples of such entities are the marketing representative offices of pharmaceutical companies, which, sometimes, in fact perform only advertising and other supporting activities. Such activities, as a rule, are not deemed business activities and these entities are not registered in the Commercial Register, and this fundamentally influences their taxation in the Slovak Republic.

Foreign entities may also conduct business in the Slovak Republic via capital investments in Slovak legal entities (companies). From the perspective of tax law Slovak companies with a capital ownership held by foreign entities are deemed entities with an unlimited Slovak tax liability (Slovak tax residents), where the residents are assessed in the same way, regardless of the ownership structure of the company. Tax implications in this case may arise through the distribution of dividends or other contractual agreements between the Slovak and foreign entity.

The indirect conduct of business is understood to mean the participation of a foreign entity in a busi-

ness activity in the Slovak Republic via commercial relations (provision of advisory services, loan contract, etc). If, for example, a foreign entity provides a loan to a Slovak tax resident, the interest revenue arising from the loan must be assessed also from the income tax aspect.

Taxation of foreign entities in the Slovak Republic

The basic principle of taxation in modern tax systems is that taxpayers are taxed on the basis of the concept of unlimited tax liability and limited tax liability (i.e. on the basis of residence and source of income).

The same classification of taxpayers is included in the current Slovak Income Tax Act. According to this act a person with permanent residency in the Slovak Republic or person that stays here for at least 183 days in the calendar year is deemed a taxpayer with unlimited tax liability. A companies having a registered office in the Slovak Republic (registered in the Slovak Commercial Register or other register) or having the place of actual management in the Slovak Republic is deemed a taxpayer with unlimited tax liability (tax resident). The place of actual management is the place where management and commercial decisions of the statutory and supervisory bodies of the company are adopted, regardless of the formal place of the company's registered office. This definition of the place of actual management and the inclusion of companies with actual management in Slovakia among taxpayers with an unlimited tax liability is in accordance with the tax principles of the OECD. One of the reasons for this is to restrict the use of companies with formal residence abroad for the transfer of profits, where the current recipient of the transfer is the resident of a tax haven.

For taxpayers with an unlimited tax liability, all incomes from a source in the Slovak Republic and from sources abroad are subject to tax. A taxpayer with unlimited tax liability is, thus, obliged to tax all its incomes in Slovakia, regardless on the current source of the income. The taxpayer may, however, in its international activities, benefit from the protection afforded by international double tax treaties concluded by the Slovak Republic with other states.

The Income Tax Act defines taxpayers with limited tax liability as all persons and companies who are not taxpayers with unlimited tax liability. For taxpayers with limited tax liability only incomes from sources in the Slovak Republic are subject to tax, unless these have been exempted from tax (or are not a subject of tax) pursuant to the Slovak Income Tax Act or pursuant to the respective double tax treaty.

Source of incomes of foreign entities

From the above it is clear that the determination and definition the source of incomes is of the utmost importance in the taxation of foreign entities. Since sources of income take numerous forms, this problem is reflected also in the definition of sources of income in national legislations providing the bases for states to apply a claim for the taxation of incomes of non residents from sources in their territory.

In principle the following basic categories of sources of income of non residents - taxpayers with limited tax liability - can be defined: (a) profits from business, (b) incomes from intangible assets, (c) dividends, (d) interest received, (e) royalties, (f) capital incomes, (g) earned incomes, (h) pensions, social payments.

In the following text we examine in more detail in particular the first category, i.e. profits from business.

Permanent establishment

One of the standard ways for foreign entities to gain incomes from a source in another state is through conducting a business activity in that state. Foreign entities performing business activity in the Slovak Republic may gain income sources either directly by means of a permanent establishment, or indirectly (indirect forms of business).

A permanent establishment is a place by means of which an enterprise of one contracting state conducts business in another contracting state. The application of the occurrence of a permanent establishment is the result of arguments of the conflicting interests of the states involved (for the state in which the enterprise is resident it is advantageous that the operation does not arise, whereas for the state of the income source the case is precisely the opposite.

The concept of the occurrence of a permanent establishment, thus, lies in the determination of the source of incomes from business in a state in which a non-resident performs business activity. The main criteria used for assessing the occurrence of a permanent establishment are the performance of a business activity, the permanence of the business and the existence of a place of business.

The definition of these three criteria and their fulfilment are very important in defining a permanent establishment in domestic legislation. Usually it is not too complicated to assess the fulfilment of these conditions where there exists a fixed place of business - in particular in the case of a production activity or the provision of services in premises used by the enterprise. Tax legislation uses, in particular, expressions such as the place of management, branch, workshop, etc. The problem is of a much

greater order when assessing the conditions for the occurrence of a fixed operation where this concerns the provision of services. This issue is resolved partly by the time test, i.e. the determination of the occurrence of a fixed operation as the provision of services by employees in the territory of another state for a minimum period of time, for example 183 days, 9 months, 12 months, etc.

A permanent establishment of a foreign entity does not arise exclusively through the direct conduct of business, but for example also through the activity of a dependent representative in the territory of the given state (and the specific fulfilment being the condition of a place of business). A dependent representative is deemed to be a person acting on behalf of an enterprise of a non-resident, where this person's activity leads to the business activity of the non-resident in the given state. Such a person is deemed a dependent representative only if they are legally and economically dependent on the non-resident's enterprise, despite the fact that they may be formally self-employed. The acting person's dependence, or independence, is assessed on the amount of liabilities that they have towards the given non-resident.

A further important aspect in defining a permanent establishment is the meaning of the term "permanence of business". The permanence of a business is very important for the taxation of foreign entities, because one-off activities, as a rule, are not taxed in the state of their source, but rather in the state of the foreign entity's registered office.

One of the basic principles of the occurrence of a permanent establishment is also that the existence of a subsidiary in one state does not mean the occurrence of a permanent establishment of the parent company (with its registered office in another state) in this state.

The potential occurrence of a permanent establishment is in practice often an important factor in the investment decision making process of business entities, in particular if the differing tax legislation of the states involved has a significant effect on the net amount of incomes from the investment.

A permanent establishment is in principle treated in the same manner as a tax resident - a company. The tax liability is determined from the tax base, which arises through the transformation of the accounting result. The tax base of a permanent establishment, however, may be determined also by means of methods defined in the Income Tax Act.

Sources of income of foreign entities pursuant to the Income Tax Act

The tax liability of foreign entities is determined according only to the legislation of the state from which an income source flows in the case of residents of states with which the income source state does not have concluded a double tax treaty. In the case of taxpayers of treaty states the provisions of the respective double tax treaty are applied. Double tax treaties, however, merely modify the application of domestic legislation and, therefore, it is not possible to impose a tax liability simply on the basis of a double tax treaty. This means that in the taxation of foreign entities the tax liability is always based on domestic tax legislation and the respective double tax treaty is applied subsequently. In the application of double tax treaties the harmonisation of principles and terminology in the Slovak Income Tax Act with OECD principles and terminology can be viewed as positive.

The Income Tax Act deems as incomes of taxpayers with limited tax liability from a source in the Slovak Republic financial and non-financial fulfilment from incomes, which are classified into the following categories:

a) incomes from activities operated by a permanent establishment,
b) incomes from dependent activity,
c) incomes from services, consultancy, managerial and intermediary activities,
d) incomes from the activities of artists and sportspersons,
e) other incomes,

The Income Tax Act defines the first category as profits from business and from activities performed through a permanent establishment, including incomes from administering of its assets.

The theoretical definition of the term permanent establishment has been given in the preceding text. It is precisely the field of defining the permanent establishment that has seen a shift in the new Income Tax Act towards OECD principles. For example the Slovak definition of a place of business has been supplemented by a place from which a taxpayer's activities are organised. Further specification has been made in the definition of a permanent establishment of a person deemed a dependent representative (agent). The previous definition placed emphasis less on economic dependence, which is crucial to the definition's essence of a dependent representative. Therefore Slovak Republic's tax legislation in the past did not include all possibilities of the occurrence of a permanent establishment created on the basis of the activities of a dependent representative pursuant to OECD principles. In the new legislation there has been implicitly supplemented also the term "economic dependence", which arises if the representative acts on the basis of instructions of a foreign entity that controls the results of the representative's activity and bears the business risk.

The act has expanded the definition also to include a definition of the term permanence of a business. The permanence of a business concerns the fact as to whether the facilities for performing the business are used systematically or repeatedly. If the business is performed on a one-off basis, the place or facilities in which the business is performed are deemed permanent if the length of time for performing the activity exceeds a certain period of time (in the Slovak Republic six months).

Income gained through a permanent establishment is also deemed the income of partners in a general partnership, partners in a limited partnership and members of a European grouping of economic interests with a registered seat in the Slovak Republic, where this concerns taxpayers with limited tax liability.

A second income group comprises incomes from dependent activity (we do not include free trades in this category), which is performed in the Slovak Republic or on boats under the Slovak flag or on board Slovak aircraft. In connection to this it is necessary to state that the Slovak Republic does not allow persons – non-residents to apply the same items reducing the tax base as Slovak tax residents, something which could fulfil certain criteria determining discrimination prohibited by primary EU law.

A further group of incomes from a source in the Slovak Republic comprises fulfilment from the provision of services of commercial, technical or other consultancy, from the provision of services, from managerial and intermediary activity and from similar activities provided in the Slovak Republic, where these are not incomes gained by means of a permanent establishment. In practice it is quite often difficult to assess the place from which services are provided, therefore it is appropriate to incorporate the place of performing the services into the contractual relationship on the basis of which the services are provided. The reason for the special definition of these activities in the Income Tax Act is the fact that the remuneration for these services is often used for the transfer of untaxed profits abroad. The philosophy of the provisions has been imported from the model tax convention drawn up by the United Nations, which through similar provisions resolves the conflict between developing countries and advanced economies in the division of profits from business.

The fourth category comprises incomes from the activities of artists and sportspersons or co-operating persons and from other similar activity personally performed or assessed in the Slovak Republic.

The last group includes incomes of a various nature and, in general, they are defined as payments from companies with a registered office or persons with a residence in the Slovak Republic, where these incomes are not gained by means of a permanent establishment; and from the permanent establishment of taxpayers with a registered office or residence abroad, and which are in particular:

– payments for the provision of a right to use or for the use of a subject of industrial ownership, computer programs, designs, models, plans and know-how,
– payments for the provision of a right to use or for the use of copyrights or related rights,
– interest received or other revenue from loans provided and deposits,
– rent or income flowing from other use of intangible or tangible things located in the Slovak Republic,
– incomes from the sale of intangible and tangible things (including Slovak securities, and property rights) located in the Slovak Republic,
– remuneration to members of the statutory bodies and other bodies of legal entities,
– winnings in lotteries and other games, social payments and pensions.

This group includes in particular incomes from indirect business in the territory of the Slovak Republic ensuing from business relations, based largely on the essence of ownership separated from the use of things in the framework of two states and also income from capital assets. It is these relations, with regard to the general principle of contractual freedom and the variety of solutions ensuing from this, that cause many complicated legal and economic links and their tax consequences that can fall to foreign entities' income from source in the Slovak Republic. Such standard contracts include, for example, loan contracts, rental contracts, brokerage contracts, etc.

With regard to the taxation of incomes of foreign entities classified in the last group, tax is, as a rule, applied by means of withholding tax, which the Slovak subject paying the financial sum to the foreign subject is obliged to withhold. In this regard it is necessary to draw attention to the significant specific feature of the Slovak Republic, which does not tax income in the form of distribution of dividends, settlement share, and liquidation surplus.

A taxpayer with limited tax liability in Slovakia is obliged tax all its incomes which are deemed income from sources in the Slovak Republic. These incomes form a separate tax base, where individual types of income are subject to the single tax rate of 19%. This fact represents an approximation towards two new principles of Slovak tax legislation – equal taxation of all types of income and equal taxation of all subjects. The respective tax is collected in the form of deductions or directly.

Withholding tax and tax securing

The administration of the tax liabilities of foreign entities is complicated for tax authorities especially from the aspect of collecting tax and auditing of foreign entities. These complications are made the more so in particular by the fact that these foreign entities do not have to be present in the Slovak Republic at all. Proving of the actual amount of incomes of such entities is also incredibly difficult.

Due in particular to the impossibility of effectively administering the tax liabilities of foreign entities gaining incomes from sources in the Slovak Republic two special institutes of tax law are applied – withholding tax and tax securing. The main feature of both institutes is the transfer of responsibility for payment of the tax to the paying subject (i.e. to the Slovak taxpayer which pays or credits a settlement). The Slovak taxpayer is thus obliged to ensure the tax, which the foreign entity is obliged to pay. If a Slovak taxpayer does not fulfil its obligation with regard to withholding tax or tax securing, the tax authority may impose a fine and the Slovak taxpayer is liable for the tax as if it were its own.

In taxing of foreign entities Slovakia applies, via withholding tax, an equal rate of tax as in the case of Slovak entities, i.e. 19%. If a taxpayer with limited tax liability is the resident of a state with which Slovakia has concluded a double tax treaty, the tax regime imposed by this treaty is applicable. As a rule, double tax treaties reduce the tax burden in international taxation and limit the tax liability of taxpayers with limited tax liability (tax non-residents). Pursuant to double tax treaties withholding tax does not exceed 5% to 15%. In the case of incomes falling under withholding tax it is important to repeat that always the Slovak taxpayer is responsible for submitting these incomes for taxation. Through the collection of the withholding tax the tax liability of the foreign entity is fulfilled.

The institute of tax securing means that a person or company with a residence or registered office in the Slovak Republic and permanent establishments of foreign taxpayers who pay settlements in favour of foreign entities are obliged to deduct (secure) a tax prepayment in the amount of 19% of a settlements. Tax securing is deducted only from income from sources in the Slovak Republic. It is not applied in the case of incomes from which tax is collected via withholding tax. The foreign entities should settle their final tax liability via the tax return for the respective tax period.

This approach is, however, problematic in the case of incomes in the last category (arising especially on the basis of indirect business), which do not fall under the institute of withholding tax, or rent or interest received. Also problematic is the determination of the rate of the tax securing prepayments and at the same time also the way of proving expenses in the tax return.

A further problem could according to our model be the conflict in the application of tax securing in respect of residents of EU member states with a prohibition against discrimination in primary EU law, since in this case the Slovak Republic applies a different treatment than towards its own residents, whereby it probably violates the given prohibition against discrimination.

Similarly as in the case of withholding tax, if the deduction of the tax securing is not correctly performed, the payer is liable in the same way as if for unpaid tax.