UNIWERSYTET ZIELONOGÓRSKI

DYSKURS PRAWNICZY I ADMINISTRACYJNY 3/2022 ISSN 2657-926X

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Tax audit and tax sanctions

Keywords: Tax, Sanctions, Control, Remission of Tax Sanctions

Summary. The text is devoted to the relationship between sanctions and control procedures in tax administration in Czech tax law. After defining the individual types of sanctions, the system of sanctions arising in connection with controls carried out by tax administrators is analyzed from the perspective of profitability for public budgets and related impacts. An integral part of the text is a future outlook and an indication of possible directions of development in the area of sanctions that could mean an increase in the revenues of public budgets.

Kontrola podatkowa a sankcje podatkowe

Słowa kluczowe: podatek, sankcje, kontrola, umorzenie sankcji podatkowych

Streszczenie. Artykuł dotyczy relacji między sankcjami i procedurami kontrolnymi stosowanymi przez administrację podatkową na podstawie przepisów czeskiego prawa podatkowego. Po zdefiniowaniu poszczególnych rodzajów sankcji został poddany analizie system sankcji funkcjonalnie związanych z kontrolami przeprowadzanymi przez organy podatkowe. Jest on rozpatrywany z punktu widzenia następstw fiskalnych dla budżetów publicznych, które mają źródło w przepisach prawa podatkowego. Integralną częścią tekstu jest zaproponowanie zmian prawnych, które są ukierunkowane na optymalizację sankcji, aby mogły one wygenerować większe wpływy budżetowe.

Introduction

For the proper functioning of the taxation system, it is essential that taxpayers comply with the set rules. The fiscal function of taxes, i.e. raising funds for public budgets, which then finance public expenditure, cannot be fulfilled without this. Closely related to this issue is the definition of tax penalties, which are an absolutely essential element of tax regulation. Their purpose is both to punish entities that have violated legal norms and to prevent them from committing tax offences.

The issue of tax penalties has been the subject of repeated expert debates over the last few years in the Czech Republic, which, however, have tended to limit the level of penalties in favor of tax subjects. In addition, there are new efforts to rela-

tivize certain sanctions, especially in the context of the COVID-19 pandemic and the current economic situation. However, expert opinions have neglected or completely ignored the need to find a relevant level of tax penalties, focusing instead on justifying a reduction or full remission of penalties. This can be accepted from the point of view of taxpayers, but not from the point of view of public budgets.

The following text is devoted to penalties arising as a consequence of control procedures in tax administration and their projection. The hypothesis to be tested is that the system of tax penalties in the Czech Republic is set in contradiction with the fiscal function of taxation.

1. Tax sanctions in the Czech Republic

Tax law in the Czech Republic regulates a wide range of sanctions, with different consequences for individual violations. Thus, it is possible to distinguish among breach of an obligation of a non-monetary nature, breach of the principle of courtesy and cooperation, late filing of a tax claim, breach of the obligation to declare tax in the correct amount, late payment of tax and possibly other specific sanctions. It is already apparent from this list that the sanctions cover a wide range of situations in order to motivate operators to comply properly with their obligations. Individual sanctions are then imposed as a consequence of, during or as part of the overall tax administration activity.

In the case of non-monetary infringements, a fine is imposed for failure to comply with the notification, reporting or recording obligations[1]. An example is the late (or no) submission of a VAT registration. The purpose of this penalty is to penalize non-compliance with administrative obligations by taxpayers where such non-compliance has (or may have) an impact on the tax administration itself. The amount of the fine may be up to CZK 500,000 (approx. EUR 20,000).

An orderly fine may be imposed for offensive submissions to the tax administrator[2], disobedience of an official's instruction or for disturbing the peace[3]. Here too, the fine can be up to CZK 500,000 (approx. EUR 20,000). Typical situations are heated negotiations during tax inspections, witness interviews, etc.

The third type of penalty penalizes late filing of tax returns, with the amount of the penalty depending on the length of the delay and the amount of tax assessed[4].

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[1] Section 247a of the Tax Code (Act No. 280/2009 Coll., Tax Code, as amended).

[2] In practice, there is a well-known case of the imposition of this fine in a case where the audited construction company delivered the required tax documents mixed with construction debris to the tax authorities in a box.

[3] Section 247a of the Tax Code.

[4] Marginal breaches of the obligation – a delay of no more than 5 working days – are not sanctioned. See section 250 of the Tax Code.

The taxable person is thus liable to pay a penalty of 0,05% of the tax assessed for each day of delay, up to a maximum of 5% of the tax assessed; in the case of tax loss, the penalty is set at 0,01% for each day of delay. The absolute limit is then set at CZK 300 000 (approx. EUR 12 000). This penalty is also imposed if an audit finds that the return was not filed when it should have been filed.

In the context of control procedures in tax administration, the most common consequences are penalties in the form of penalty and/or tax interest; however, by the nature of the case, all of the above penalties may be imposed when infringements of other obligations are detected.

A penalty is incurred when there is an assessment of tax, except where the entity files a supplementary tax claim. The amount of the penalty shall be 20% of the amount of the tax assessed or 1% in the case of a reduction in the tax loss. The penalty is considered[5] a penalty for failure to comply with the obligation to declare tax and is a barrier to possible criminal prosecution of the subject under the principle *ne bis in idem*.

Tax interest, in turn, penalizes the failure to comply with the payment obligation on time, both from the point of view of the tax subject and the tax authorities. The tax subject may be liable to pay interest on late payment or interest on the amount withheld, while the tax authority may pay interest on incorrectly assessed tax, on a refundable overpayment or on a tax deduction. In addition to the cost of money itself, tax interest contains a penalty which should force taxpayers to pay their payment obligations on time.

Apart from penalties, interest on late payment is the most frequent consequence of control procedures in situations where the tax administrator finds a mistake regarding the amount of tax and the tax subject is subsequently obliged to pay the difference in tax. The delay in payment from the due date to the date of payment then gives rise to interest at a rate based on the central bank repossession rate and the first day of the debt[6]. To illustrate, the amount of interest on the delayed amount in the case of the start of the tax debt in the second half of 2022 is 15% per annum.

The interest on the unjustified tax assessment is set at the same rate as the interest on the delayed payment, which is paid by the tax administrator in the event that the tax assessment differs from the taxpayer's claim, the taxpayer pays the tax assessed and the tax assessment is subsequently cancelled for illegality.

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[5] Judgment of the Supreme Administrative Court No. 4 Afs 210/2014-57 of 24 November 2015.

[6] Section 252 of the Tax Code, in conjunction with Government Regulation No. 351/2013 Coll., which determines the amount of interest on delay and costs associated with the claim, determines the remuneration of the liquidator, liquidator and member of the body of a legal person appointed by the court and regulates certain issues of the Commercial Bulletin, public registers of legal and natural persons and registers of trusts and registers of data on beneficial owners.

A specific tax interest related to the control procedures is the interest on tax deductions[7], which, in accordance with European legislation, penalizes a prolonged examination of the tax deduction declared in the tax claim. The interest accrues from the day following the expiry of a period of 4 months from the end of the deadline for filing a proper tax claim or, in the case of late filing, from the date of filing. The amount of this interest shall be half of the interest on late payment (i.e. currently 7,5% per annum).

It is clear from the above overview that the system of penalties affects different situations, and that the level of penalties is appropriate – they are not liquidating penalties, but at the same time they provide sufficient incentive for entities to fulfil their obligations properly and on time.

2. Tax administration control procedures

The tax administrator has the legal power to control the fulfilment of obligations by tax subjects. This power is an integral part of tax administration and without it, the proper functioning of public budgets cannot be assumed, as without sanction mechanisms, entities would probably not fulfil their tax obligations.

In the Czech Republic, the tax administrator can examine the amount of tax claimed or assessed under the control procedures of the removal of doubt procedure and the tax audit. It is worth noting that it is solely up to the tax administrator to initiate the control procedure (if the conditions are met).

The procedure for the removal of doubts is a procedurally simpler method of examination, with the requirement for its application being the existence of specific doubts as to the correctness of the tax. A specific doubt means a reasonable doubt, not a certainty of incorrectness, but it typically refers to findings from other audits of other entities, findings from the tax administrator's own records, etc. Thus, in practice, this may refer to obvious mistakes in the tax claim (typos in numerical values), but also to factual doubts (failure to provide mandatory annexes proving certain claims, doubt arising from findings from an inspection at the supplier, etc.). In principle, the procedure for the removal of doubts is quick, the tax administrator starts the procedure with a call for the removal of doubts, on the basis of which the subject can explain and remove the specific doubts communicated, make comments on them, and may support them with evidence, while having the obligation to prove the correctness of his claims. On the basis of this procedure, the tax will be assessed, although it may, of course, be assessed at an amount dif-

[7] Section 247a of the Tax Code.

ferent from that claimed in the tax return. However, only in certain cases a penalty payment will be due.

A tax audit, on the other hand, represents a more significant interference to the rights of the taxpayer and is a more complex, more detailed and more common procedure in practice. It should be pointed out that the tax administrator may initiate a tax audit at any time during the tax assessment period, the basic length of which is three years from the end of the period for filing a proper tax return. In the case of a tax audit, it is no longer necessary to have specific doubts about the correctness of the taxpayer's claims, and random audits are also permissible, but in practice audits are overwhelmingly initiated on the basis of an evaluation of various criteria and information[8]. As a result, the tax is usually determined differently[9]. If the tax authority assesses the tax ex officio, the subject is also obliged to pay a penalty.

The system of control procedures can be considered adequate to the needs of the tax administration authorities. It is a system that has been in use since 1993, and there have of course been successive amendments, but these adjustments are only responses to recent court decisions or findings of the need to respond to practical experience.

3. Control activities from an economic perspective

Control procedures in tax administration are mainly a preventive institute. Looking at the statistical indicators of the tax audits carried out, it is evident that the amounts of tax assessed are quite insignificant from the point of view of public budgets (about 0.5% of tax revenue)[10]:

Year	Quantity of tax audit	Detection of misconduct	Effectivity	Tax difference (in 1000 CZK)	Tax difference to 1 audit (in 1000 CZK)
2010	69 820	–	–	8 270 849	118
2011	47 472	–	–	6 685 979	141
2012	42 466	19 216	45,30%	8 430 760	199
2013	33 549	15 198	45,40%	8 228 542	245
2014	37 123	15 735	42,40%	9 614 461	259

[8] The exact algorithm is logically unknown. Typically, the findings are from tax audits of the tax entity's customers or suppliers, or systemic audits focused on a particular area – most recently bond financing, advertising services, etc.

[9] In 15 years of practice, the author is aware of only one case where the tax was not determined differently.

[10] HARAŠTOVÁ, Nikola. Tax sanctions and their revenue to the public budget (Daňové sankce a jejich výnos do veřejného rozpočtu) [online]. Brno, 2022 [2022-09-26]. https://is.muni.cz/th/vj4e5/. Master thesis. Masaryk University, Faculty of Economics and Administration. Thesis supervisor Jan Neckář.

Year	Quantity of tax audit	Detection of misconduct	Effectivity	Tax difference (in 1000 CZK)	Tax difference to 1 audit (in 1000 CZK)
2015	27 447	12 947	47,20%	15 721 315	573
2016	18 940	10 198	53,80%	14 509 879	766
2017	13 971	8 458	60,50%	11 594 254	830
2018	11 715	7 032	60,00%	10 149 312	866
2019	10 408	6 416	61,60%	7 155 425	687
2020	6 753	4 594	68,00%	5 946 805	881

The above overview shows that the number of tax inspections is steadily decreasing, but at the same time the effectiveness of inspections (i.e. the ratio of inspections with detected errors and tax assessed to the number of inspections overall) is increasing significantly; the average amount of tax assessed per inspection is also increasing. This indicates a systematic approach of the tax administration, analysis of risk subjects and other factors, on the basis of which subjects are targeted for audit.

It is not known from publicly available data how individual taxes are represented in these figures. However, given the existence of control reports as an additional control mechanism in the VAT administration, it is generally known that VAT controls are overwhelmingly carried out on entities where there is a presumption of tax evasion – typically VAT fraud, involvement in chains, findings from international cooperation, etc.

However, it is also worth pointing out that the selection of entities to be audited is not based solely on a systemic analysis of economic indicators or suspicions of the tax administration, but for capacity reasons there is further selection both in terms of substance and numbers. In terms of substance, cases that could potentially lead to a tax assessment are excluded from the audits, but the probability of finding wrongdoing is not high. These are typically situations of unclear legislation. In terms of the number of checks carried out, entities are then selected which are more likely to be subject to a tax assessment than others (i.e. taking into account the principle of efficiency of management). In addition to the entities resulting from the risk analysis, the individual first-instance tax administrations have the possibility to carry out checks on the entities selected by them, which serves to control the entities in a certain business area.

The exact mechanisms for selecting the entities to be audited are not known, but the number of audits carried out already shows that 'small frauds'[11] cannot be detected or are detected randomly. From this perspective, it is the control report that has enabled the tax administration to detect VAT fraud in a systematic way,

[11] This is a violation of tax law that is not apparent at first glance – for example, an increase in tax-effective costs that reduce the tax base that does not deviate from the values of past returns.

whereby entities automatically indicate who is their customer and who is their supplier. Such records then allow the tax administration to analyze chains easily.

Furthermore, the number of checks carried out must be related to the number of businesses that are most frequently subject to checks. In 2021, the number of economic entities in the Czech Republic was 2,976,264, of which 2,037,637 were private entrepreneurs and 543,037 were commercial companies[12]. It is therefore quite clear that the probability of an inspection is approximately 0.3%, including the above-mentioned specifics of targeted inspections according to analyses, etc.

4. Relativization of sanctions

From the above defined system of sanctions, it appears that it is a comprehensive set of consequences of breach of obligations by individual subjects, which should discourage the commission of tax offences. In this context, however, it is necessary to point out the numerous exceptions which undermine the established system of sanctions and relativize both the creation and, where appropriate, the amount of the sanction itself.

When considering the impact of the most common penalties arising as a result of control procedures in tax administration, i.e. penalties and interest on late payment, it is worth emphasizing that these penalties may not arise at all. As regards interest on late payment, this will typically be a situation (although not very frequent in practice) where the entity in question has an overpayment of tax recorded with the tax authority at least equal to the amount of the tax difference determined. Interest on late payment accrues only on the amount not paid on the due date. The existence of the overpayment is offset against the underpayment of the tax difference and the entity does not incur the penalty at all, since it does not arise at all.

In addition, the incurrence of the penalty is dependent on when the tax authority initiates the procedure for the removal of doubts or the tax audit. Both of these control procedures may be initiated before the first assessment of the tax (in practice, this is typically the case when a VAT claim is submitted and the tax authority immediately initiates a tax audit based on its own findings). If, on the basis of the control procedure, the tax is first assessed, albeit in an amount different (higher) than the tax claimed, this difference is not sanctioned by a penalty. However, this distinction is illogical from the point of view of the purpose - the penalty is applied only and exclusively on the basis of the decision of the tax administrator when he carries out his control activity. Thus, in the case of a quick start of the in-

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[12] Economic entities – time series. [online]. Český statistický úřad. [2022-09-26]. https://www.czso.cz/documents/10180/23188653/crescr012422_1.xlsx/5ddfda1e-8f86-4f90-a93a-870c7eae172d?version=1.1.

spection activity, no penalty is incurred, even though the findings are the same as in the case of later started inspections.

This approach therefore creates inequality between subjects, since the same conduct may be sanctioned in one subject and not in another, simply because the tax administrator carries out the inspection activity before the first tax assessment.

Under the current legislation, a penalty only arises if there is a tax assessment, and this is in addition to the situation where the subject files a supplementary tax return. Typically, penalties are incurred in the case of spot checks or checks on the relevant facts for an earlier period.

It is apparent that penalties arise only as a result of, or in direct connection with, part of the control procedures. In addition, however, it is possible to apply for a waiver of penalties[13]. The statutory legislation lays down rather vague rules, with the decision on waivers being entrusted to the tax administration authorities. In order to unify the decision-making practice, an internal normative instruction has unified the facts, the actual fulfilment of which may be considered as grounds for the remission of the tax surcharge under the statutory regulation[14].

Both the formal conditions and, in the context of the substantive assessment, the relevant facts relevant to the case under consideration are assessed. As regards the formal conditions, the procedure is strictly an application procedure initiated by the taxpayer's submission of an application within the prescribed period. At the same time as the application is made, the tax in question must be paid. The substantive assessment then examines the fulfilment of the conditions for the actual possibility of a waiver on the basis of a (also past) serious breach of tax or accounting rules. It is only when these conditions are met that the extent of the remission is subsequently assessed, where the instruction presupposes specific facts which are decisive for determining the extent of the remission[15].

The enumeration of the situations and the consequences for the decision on waiver has the consequence for taxpayers that the tax administrator is bound by the instruction and, as a result, the taxpayer is entitled to a waiver of the penalty, albeit in part. Thus, although the legislation provides for a coherent system of tax penalties, these are relativized through the decision to waive ancillary charges to the extent that in some cases penalties are not incurred at all (as they are waived) or are significantly reduced.

[13] See section 259 et seq. of the Tax Code.

[14] Instruction No. GFR-D-47 to the remission of tax accessories. [online]. Finanční správa. [2022-09-26]. https://www.financnisprava.cz/assets/cs/prilohy/d-sprava-dani-a-poplatku/Pokyn_GFR_D_47.pdf.

[15] For example, if the presentation of demonstrably altered or falsified documents is found, even if other conditions are met, the decision will be that the penalty is not even partially forgiven.

The effects can be illustrated by a subject which has so far duly fulfilled its obligations and, on the basis of a tax audit, has been assessed a corporate income tax base of CZK 5,263,158 and a tax of CZK 1,000,000. Under the general rules, it would be liable to pay a penalty of 20% of the tax assessed, i.e. CZK 200 000. However, in view of the fulfilment of the conditions for waiving part of the penalty, a decision will be taken to waive the penalty to the extent of 75%, so that the penalty will represent only 5% of the tax assessed (CZK 50 000). From the point of view of the tax subjects, such a penalty seems to be an acceptable risk. On the one hand, a taxpayer may gain CZK 1,000,000 in tax savings by breaching its obligations and "trying it on". In the case of an inspection carried out before the tax is assessed, the penalty will not arise at all and if the inspection is delayed, the tax subject will pay the same amount of CZK 1,000,000, but in addition, he will only pay CZK 50,000 more in penalties. If we take into account the limited time limit for the implementation of the control procedures, namely 3 years, combined with the number of controls and the total number of subjects, it is evident that the probability of control and therefore the imposition of penalty is absolutely minimal.

5. Options for adjusting tax penalties de lege ferenda

Tax penalties underwent a major legislative revision on January 1st, 2021, so it would be reasonable to assume that the legislator should not interfere with the penalty system in the foreseeable future. Although no amendment to the procedural regulations is currently being prepared in this respect, in the light of the current unsustainable state of public finances, there is beginning to be loud talk of extraordinary interventions in the tax system, either in terms of introducing new taxes[16] or in relation to sanctions by waiving them systemically as part of a partial tax amnesty.

In September 2022, a bill on extraordinary forgiveness and extinction of certain tax debts was introduced[17], which provides for the extinction of certain tax arrears and the forgiveness of interest. The proposal does not provide for the waiver of penalties at this time, but it is questionable in what form the bill will be adopted.

However, from a general point of view, the waiver of penalties, albeit on the basis of a law, is unsystematic and introduces further unfairness among taxpayers. The entity that pays its obligations properly and on time will pay the tax assessed, including the penalty, if applicable, and will not be entitled to remission of interest on late payment. By contrast, a taxpayer who has incurred an obligation to pay

[16] For example windfall tax, or a sectoral income tax increase.

[17] The proposal of the Extraordinary Forgiveness and Extinction of Certain Tax Debts Act [online]. Úřad vlády České republiky. [2022-11-21]. https://apps.odok.cz/veklep-detail?pid=KORNCH7GP50B.

but has not fulfilled its obligation by the relevant date will be entitled to apply for remission and will be granted it. However, such an approach is contrary to the fundamental constitutional limits on the imposition of taxes, where the distinction between subjects in this respect is unequal and unjustifiable.

Notwithstanding the above extraordinary interventions to the legal order, it is proposed to make changes in order to protect public finances. Relativization or systemic remission of penalties has an impact on public budgets. It is not possible to accept a situation in which it pays for entities to try to break tax law, knowing that if the tax authorities find out about the wrongdoing, the consequences are (compared to the potential gain) quite marginal.

The solution is therefore to increase penalties or at least to limit the possibility of waivers to isolated cases. Such a change would motivate taxpayers to fulfil their obligations properly and pay taxes in the correct amount. Consequently, public budgets would receive an appropriate amount of tax revenue.

At the same time, the control activities of tax administrations should be intensified or the time limit within which a tax entity can be audited should be extended. The longer the time limit, the longer the entities would live in uncertainty as to whether the tax authorities would find out about their misconduct. This change would also lead to a disincentive for subjects to commit tax offences.

It is also worth considering extending the penalty to situations where the tax is assessed at a different amount than the taxpayer claims, regardless of when (at what stage of the proceedings) the decision is taken.

Conclusion

An independent assessment of the current system of tax penalties in the Czech Republic leads to the conclusion that the rules set up suit tax subjects, who are only obliged to pay penalties in a limited number of situations. Taking into account the relatively short period of time for carrying out an audit, taxpayers often choose the "I'll try" option and commit tax offences even though they are aware of the breach of tax law.

Recently, the tax inspection system has been modified and the changes made have resulted in a reduction in tax revenue for public budgets[18]. Through the decision on the waiver of penalties, it is then impossible to come to any other conclusion than that the hypothesis has been confirmed – the system of tax penalties in the Czech Republic is set in contradiction with the fiscal function of taxation.

[18] On January 1st, 2021, there was a 6 bps reduction in interest.

However, with minor changes to the legislation, the fiscal function can be emphasized, but such a setting requires a politically unpopular step and it is therefore questionable whether the legislator will decide to go down this route. In the current state of public budgets, this is not a major difference in collections, but at the same time such a change could lead to more taxes being levied on a voluntary basis.

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