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Tax Reliability Index - an effective incentive tool or an unlawful concept?

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In her article, the author analyses the new concept of tax reliability index. She points out the drawbacks of the legislation, which do not comply with the rule of law. The aforementioned drawbacks may result in the concept failing to achieve its objective.

Tax Reliability Index – an effective incentive tool or an unlawful concept?

Let me start by noting that I have always been, and continue to be, in favour of initiatives based on 'rewarding' good taxpayers and penalizing those who fail to duly fulfil their obligations. Indeed, I believe that compliance with the law, including tax legislation, is more effectively ensured by such measures, rather than by audits or other formal enforcement by public authorities. The authorities can implement such means to a limited extent only, and at present they, unfortunately, do not have enough trained staff to do that. However, to be truly functional and motivating, such a concept must be based on robust and transparent foundations, and its implementation should not be hindered by drawbacks directly affecting the rule of law.

The Constitutional Court of the Slovak Republic states that ”the sphere of taxes (or fees) belongs to the group of ’political issues’, where a higher degree of autonomy of the legislator shall be observed”[1], but this autonomy is not limitless. “Referring to the provisions of tax laws, a constitutionally acceptable interference with the fundamental right to conduct business may be considered an interference which:

1. *is carried out in compliance with the principle of legality;*
2. *pursues a legitimate aim and has a rational basis;*
3. *does not impose a demonstrably disproportionate burden on business and is not extremely disproportionate to the relevant public interest;*
4. *does not constitute a manifest or arbitrary breach of the constitutional principle of equality, including in conjunction with the protection of the fundamental rights of entrepreneurs.*”[2]

I outline below why, in my opinion, these principles were not observed when passing tax reliability index legislation.

I. Basic concept of the tax reliability index

The tax reliability index, pursuant to Section 2(h) of Act No. 563/2009 Coll., on Tax Administration and on amendments and supplements to certain acts (hereinafter the “Tax Code”), means “the assessment of a taxable entity, that is an entrepreneur registered for income tax, on the basis of criteria defined by the fulfilment of his obligations to the tax administrator under this Act or under special regulations, and on the basis of his financial indicators.”

On a basis of points allocated to the taxpayer and his financial indicator (currently only one is quantified, although the legislation provides for more), the final result is the assignment of one of four types of indices to the entrepreneur, specifically:

- a highly reliable taxable entity if the taxable entity is assigned a maximum of 10 points, inclusive, and the financial indicator condition is met at the same time (see Chapter II. 2 for details of the financial indicator calculation);
- a reliable taxable entity if (i) the taxable entity is assigned more than 10 points and less than 25 points, i.e. up to and including 24 points, or (ii) up to and including 10 points, and the financial indicator condition is not met;
- an unreliable taxable entity if the taxable entity is assigned 25 points or more; and
- an unassessed taxable entity if the taxable entity does not meet the conditions for inclusion in the set of assessed entities.[3]

Under the foregoing categories, highly reliable [4] or reliable[5] taxable entities are legally entitled to more favourable treatment by the tax administrator while, conversely, the law stipulates stricter treatment of unreliable taxpayers by the tax administrator, e.g. by always setting an eight-day limit for the performance of the action[6]. Consequently, the tax reliability index affects other rights and obligations of taxpayers as a result of the application of other provisions of the Tax Code, such as effects on the determination of the amount of fine levied for tax-related offences[7] or on the applicable amount of fee for issuing a binding opinion[8]. Another measure related to the index is the disclosure of the tax reliability index assigned to individual taxable entities (see Chapter II. 4 for more details).

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1 Judgment of the Constitutional Court of the Slovak Republic PL. ÚS 9/2014-63, p. 16

2. Judgment of the Constitutional Court of the Slovak Republic PL. ÚS 14/2014-72, par. 77

II. Legislative framework for the tax reliability index-legality principle

The basic legislative framework for the tax reliability index is set out in Section 53d, which was inserted into the Tax Code with effect from 1 January 2022. The tax reliability index is legislated at three levels, specifically:

(I) in the Tax Code (in particular in the aforementioned Section 53d);
(II) in Decree No. 544/2021 Coll., on the criteria for determining the tax reliability index (hereinafter the "**Decree**");
(III) on the website of the tax administration of the Slovak Republic[9] (hereinafter the "**TA Website**").

However, only the Tax Code and the Decree carry features of a generally binding act, and neither of these two sources provides a precise catalogue of possible attributable tax reliability indices. It is merely the context of the entire legislation that allows for a deduction that there are at least the 'highly reliable tax entity' and 'unreliable tax entity' categories. Neither the Tax Code nor the Decree stipulate the threshold criteria (i.e. specific values) on the basis of which taxpayers are to be classified into individual categories[10], the method of assessment according to the financial indicator, and which authority is mandated by law to carry out the assessment.[11]

II.1 Statutory authorization

The provision of Section 53d(4) of the Tax Code[12] does indeed set out competences for public authorities (namely the Ministry of Finance and the tax administration), but the Decree as a generally binding regulation merely specifies which obligations need to be satisfied for the determination of the tax reliability index. The definition of specific criteria and the mechanism of how the index is drawn up are not laid down either in law or in a subordinate regulation-the Decree. The index is de facto assigned using the mechanism posted on the TA website. The published information is subject to change without a proper legislative process. The TA website is often updated and changed, and its structure and content have

changed several times during 2022 (the last update known to the author of the article was made on 27 June 2022, previously on 20 May 2022). For some time, this information had not been available at all (this deficiency was brought to the attention of the tax administration and was subsequently rectified).[13]

In this context, it is also worth noting that the Decree lists 'only' 13 criteria for determining the tax reliability index. According to the TA website, however, the index is assigned on the basis of 15 criteria, which are not even formulated in the same way as the criteria set out in the Decree. This leads to the conclusion that, by this measure alone, the tax administration overstepped its competences in formulating the criteria.

The forgoing indicates that the authorization itself, and in particular the specific procedure applied in the implementation of the index concept, are designed in a way that permits an unidentified entity to change the rules at virtually any time without any restriction whatsoever. According to the Tax Directorate, the adoption and approval process is allegedly carried out by an unspecified project team and a steering committee of the Tax Directorate in cooperation with the Ministry of Finance.

Legislation pertaining to the tax reliability index is formulated in a manner that allows the aforementioned authorities to classify taxpayers as either reliable or unreliable at their own discretion and, subsequently, grant them different rights and impose different obligations. Moreover, this arbitrary classification is made public.

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3. Only entrepreneurs (i.e. legal entities with income from business and natural persons with income from business or other self-employment) who have been registered for income tax for at least two years are subject to the assessment.

4. The calculation of benefits for highly reliable entities is posted on the Tax Administration website and is available as of 18 August at: https://www.financnasprava.sk/_img/pfsedit/Dokumenty_PFS/ Podnikatelia/Index_dan_spol/2022/2022. 07. 27_IDS_benefit_VSDS.pdf.

5.The calculation of benefits for reliable entities is posted on the Tax Administration website and is available as of 18 August at https://www.financnasprava.sk/_img/pfsedit/Dokumen- ty_PFS/Podnikatelia/Index_dan_spol/2022/2022. 07. 27_IDS_benefit_SDS.pdf.

6. Section 53d(6) of the Tax Code.

7. Section 155(4) of the Tax Code: "In determining the amount of the fine, the tax administrator shall take into account the gravity, duration and consequences of the unlawful condition and the tax reliability index."

8. Section 53c(1) of the Tax Code: "The taxable entity shall pay a fee of EUR 1,000 with the request for a binding opinion; a highly reliable taxable entity shall pay half of this amount with the request for a binding opinion."

9. Tax Administration. Tax reliability index, available as of 18 August 2022 at: https://www.financnasprava.sk/sk/podnikatelia/dane/index-danovej-spolahlivosti.

10. The Decree only lists the criteria for determining the tax reliability index, but does not provide any details on the relevance of each criterion or the period for which the criteria are monitored.

11. Section 53d(1) of the Tax Code states merely that the tax administrator will send the taxable entity a notification of the tax reliability index.

12. Section 53d(4) of the Tax Code: "The criteria for determining the tax reliability index shall be laid down in a generally binding regulation to be issued by the Ministry. The details of entitlements, financial indicators, principles and method for determining the tax reliability index of a taxable entity shall be posted by the Tax Administration on its website."

13 For some time, the site at least contained information about the date of the last update, but at the time of writing this article it was no longer the case.

II.2 Financial indicator

Neither the Act nor the Decree address financial indicators relevant for the determination of the index. According to the TA website, the indicators should be derived solely from the effective tax rate (hereinafter the "ETR"). With regard to the Explanatory Memorandum to the Tax Code amendment, it may be assumed that the pertinent factors include turnover, profits and the number of employees (I note that I do not consider this approach ideal either).[14] In this regard, the drafters of the final criteria departed significantly from the legislators' intent as stated in the Explanatory Memorandum.

Information that the relevant financial indicator for the determination of the Index is the ETR and the method of its calculation are available only on the TA website.[15] As declared there, the ETR, in addition to contributing to the state budget through the reported income tax, is also expected to take into account the social importance of the taxable entity as an employer, which is expressed through the deducted tax on employment paid on behalf of employees. The following is a rather complicated calculation of this indicator. For the sake of completeness, I will try to outline it briefly:

- The taxpayer meets the effective tax rate requirement if: ETR > ETR0;
- Calculation of ETR = 100x Income tax/(Revenue or Income), result in %, rounded to 2 decimal places;
- Calculation of the individual threshold ETR0 = 2-log(R4 Reports/1000);
- If ETR0 < 0%, then ETR0 = 0%

The determining factor is therefore the amount of income tax paid and the deducted tax paid on behalf of employees, but not the criteria reported in the Explanatory Memorandum (turnover, profits, number of employees).

II.3 Assessment period

Pursuant to Section 53d(2) of the Tax Code, the assessment period is calendar half-year. Although compliance with the set criteria is examined for some criteria for the last 6 months (e.g. criterion No. 1 - arrears for taxes and customs), for most of them it is a much longer period, in the ranks of three years (e.g. criterion No. 5 - failure to file VAT returns within the statutory deadline, criterion No. 6 - failure to file other tax returns and tax documents within the statutory deadline), and some criteria are assessed retrospectively over a period of up to five years (criterion No. 4 - failure to file income tax returns within the statutory deadline).

We might debate what the lawmakers meant by 'assessment period', since the Explanatory Memorandum does not provide any further clarification. The taxable entity may thus legitimately argue that meeting the criteria is to be assessed only for the duration of the assessment period, and that the mechanism as currently set up in this respect is contrary to the Tax Code since the assessment period for which the index is determined significantly exceeds the length of the assessment period envisaged by the law. For example, in the case of criterion No 11 - findings of tax audits, it may easily happen that points ensuing from tax liability are assigned for the taxable period of up to 10 years before the law came into force; this is because the period when the finding became final is taken into account.

II.4 Disclosure of the index

Disclosure of a determined tax reliability index may be deemed a major infringement of taxpayers' rights that also raises the greatest concerns among entrepreneurs.[16] The Slovak tax administration is to publish the index list for the first time by 30 September 2022 at the latest.[17] As of 31 October 2022 no index list was published and currently, the amendment is pending in the Slovak parliament which should postpone its publication to the first half of 2023. Although the legislators declared in the Explanatory Memorandum[18] that the index is "primarily motivational in nature and will not be an assessment of the risk level of the taxable entity, i.e. it is not intended, for example, to serve as a basis for obtaining contracts or to enter into the terms and conditions of public procurement", in practice, it is impossible to avoid such a consequence.

Publicly 'labelling' an entrepreneur as unreliable has a significant potential to affect his business. The intention to publish the index was also criticised by the academia during the comment procedure as insufficiently justified and unsystematic.[19]

The first major issue with the current concept of tax reliability index is, simply put, that the criteria for determining it are not set out in law, with the result that they can be altered virtually without limit by an unidentifiable group of persons. . In addition, it is unclear what procedure applies for the criteria setting and any change to it. This situation may be described as in conflict with fundamental constitutional principles, in particular the principle of legality.[20]

14. "The economic diversification of taxable entities will also be taken into account, where the number of employees, turnover and profits of the entity will be considered.", Explanatory Memorandum, available at: https://www.nrsr.sk/web/Dynamic/DocumentPreview.aspx?DocID=498696, (hereinafter the "Explanatory Memorandum"), p. 32.

15. Available as of 15 August 2022 at: https://www.financnasprava.sk/_img/pfsedit/Dokumenty_PFS/Podnikatelia/Index_dan_spol/2022/2022. 07. 27_IDS_EDS.pdf.

16. Section 52(18) of the Tax Code: "The Tax Administration posts on its website an updated list of taxable entities for which a tax reliability index has been determined, which includes name and surname of the natural person, address of his/her permanent residence or place of business, if different from permanent residence, business name or name of the legal entity and its registered office, tax identification number, business registration number of the organization, if assigned, and tax reliability index."

17. Section 165m(1) of the Tax Code: "The Tax Administration shall publish the list by 30 September 2022 pursuant to Section 52(18)."

18. Explanatory Memorandum, p. 32.

19. See the comment of the Law Faculty of Charles University: "Without clearly defined consequences from the above point of view, we do not consider the disclosure of individual indices to be desirable or necessary", https://www.slov-lex.sk/static/SK/EL/2021/158/LP-2021-158-vznesene-pripomienky.docx.

III. Retroactive effect of criteria

The points, or the weighting of specific criteria, the timeframe for which they are assigned, as well as the classification of taxpayers according to the points assigned, were announced

(posted on the TA website) in the second half of March 2022. Since the assessment includes infringements committed by the entity before the regulation came into force, the concept obviously contains elements of retroactivity. In the first half of 2022, taxpayers were assigned a tax reliability index for conduct dating back (up to 10 years) before legislation governing the tax reliability index concept came into force. In practice, this means that some businesses have been classified as unreliable taxable entities on the basis of criteria that retrospectively assess some of their actions taken at a time (e.g. 10 years ago) when they could not have foreseen legal consequences which these might entail.

The prohibition of retroactive effect of norms is a fundamental principle of the rule of law, which has been repeatedly reaffirmed by the Constitutional Court, e.g. in the judgment of the Constitutional Court of the Slovak Republic in Case No. PL. ÚS 3/00: "restrictive laws which have retroactive effect on closed factual situations are incompatible with the principles of the rule of law. The prohibition of retroactivity generally applies for the lawmaker.“[21] Public authorities, as well as courts, can, and even must, ensure that they apply laws and regulations in compliance with the Constitution and, accordingly, the principle of the prohibition of retroactivity, and impose penalties only for facts that occurred after the publication of the penalty.

The introduction of criteria that also examine facts that occurred prior to the entry into force of the law establishing the index not only ignored the boundaries of the mandate provided by the lawmakers in connection with the tax reliability index, but also stood in sharp contrast to the prohibition of retroactivity. This is all the more serious as it was performed on the basis of ‘rules’ that do not even meet the criteria of a generally binding regulation.

IV. Non-compliance with the ne bis in idem principle

Another issue arising from this concept is addressing the question whether additional ‘penalizing’ of taxpayers by denying them some rights or by disclosing their classification as unreliable taxable entities for a fact that has already been punished may violate the principle of ne bis in idem (not two times in the same case). Indeed, almost all infringements that warrant ‘penalty points’ in determining the tax reliability index already carry a penalty in the form of a fine under Section 155 of the Tax Code.

One may argue that the assignment of an index is not in itself a penalty. One may concur with such statement provided there are no other consequences attached to it, such as denial of certain rights, stricter deadlines, or inclusion in a published ‘list of shame’. Following many discussions with entrepreneurs, I dare say that they perceive disclosure of information that calls into question their reliability with increased sensitivity, and whereas they often pay a fine even if they do not always agree with its imposition, they consider their public ranking on the list of unreliable entities a much more severe penalty - and one with an unclear effect for the future. They are (and rightly, in my view) concerned that this information will be used by the

various entities rating the solvency of entities or assessing their credibility, including, among others, financing banks, business partners and journalists.

The foregoing opinion is also supported by professional literature: “We consider the institution of public reprimand a sanction that would clearly find its application in the current social conditions as well. Social defamation is often perceived as a more radical punishment than, for example, an ‘anonymous’ imposition of a pecuniary fine.”[22]

With regard to the above, the opinion that the decision to assign an unreliability index constitutes another type of penalty (e.g. as a restriction of procedural rights, higher penalties and fees, and social defamation through publication on the unreliable taxable entities list) for facts for which the entity has already been penalized once, may be valid. It is questionable how the courts would view such a concept in the light of the ‘ne bis in idem’ principle (the right to not be tried or punished twice), which, according to the decision-making practice of the Slovak courts, also applies to non-criminal proceedings.[23]

V. Non-compliance with the prohibition of arbitrary discrimination

In some criteria, elements of discrimination can be identified, e.g. in criterion No. 1 - arrears for taxes and customs, which assesses arrears not paid by the end of the month in which they are incurred. It means that the amount of arrears recorded as of the last day of the month is assessed, while the algorithm evaluates retroactively the balance at the end of each month of the 6- month reference period, i.e. for the months 7-12/2021 to determine the index as of 1 January 2022. The above algorithm may be viewed as discriminatory, notably because it assesses the amount of arrears at the end of the month, but not the days of delay.

I will illustrate the foregoing mechanism with an example: for a customs debt of €500,000 which is due on 2 October 2021 and the taxable entity did not pay it until 20 October 2021 (i.e. was in arrears for 18 days), the taxable entity will not receive any penalty points and will be classified as highly reliable (assuming it was not assigned any other penalty points). Conversely, a taxable entity that had an outstanding customs debt of EUR 6,000 due on 29 October 2021 and paid it on 2 November 2021 (i.e. was in arrears for 3 days) will be classified as unreliable as a result of receiving 30 penalty points. I believe that the criterion set in this way is inconsistent with the prohibition of arbitrary discrimination.

20.Art 2(2) of Act No. 460/1992 Coll., the Constitution of the Slovak Republic: “State authorities may act only on the basis of the Constitution, within its limits and to the extent and in the manner stipulated by law.”

21. E.g. The Constitutional Court of the Slovak Republic, Case No. PL. ÚS 36/95: "the requirement (principle) of legal certainty and protection of citizens' trust in the legal order, which includes the prohibition of retroactive effect of laws and regulations or their provisions, is also an inherent feature of the rule of law. In the constitutional order of the Slovak Republic, the principle applies according to which one who has acted or proceeded on the basis of trust in applicable legislation (its norms) cannot be disappointed in his trust by retroactive effect of the law or any of its provisions.”

22. PhDr. Peter Potasch, PhD.: Post-war legislation regarding administrative offences - misdemeanours in the Czechoslovak Socialist Republic and its possible reflections at present, available as of 18 August 2022 at https://www.yumpu.com/xx/document/read/36655065/notitiae-ex-academia-bratislavensi-iurisprudentiae-paneurapska-.

23. Resolution of the Supreme Court of 10 May 2011, Case No. 4 Tdo 3/2011: "the principle of 'ne bis in idem', or the right not to be tried or punished twice, can be applied pursuant to Article 4 of the Protocol to acts falling in the category of criminal offences under Slovak law, as well as to acts falling in the category of misdemeanours, in all combinations that come into consideration between them, namely 1. Criminal offence - criminal offence, 2. Criminal offence - misdemeanour, 3. Misdemeanour - misdemeanour, 4. Misdemeanour - criminal offence."

VI. Tax audit

For me, personally, the most pressing legal problem of this concept is criterion No. 11 - findings from audits performed by tax administrators, which assesses all decisions issued in the assessment proceedings that entered into force within the assessed period of 36 calendar months. In addition to considering 36 months as the assessment period rather than the statutory half-year (see Chapter II. 3), and the criterion demonstrating elements of retroactivity (see Chapter III), the taxable entity is in principle penalized for the fact that if it disagrees with the tax administrator's finding and files an administrative action (i.e. exercises its right to judicial protection), negative points are assigned despite pending court proceedings. I would like to point out that if the taxpayer disagrees with the finding of the tax audit, it is obliged to pay the amount ordered by the tax administrator before the court proceedings are initiated. Nowadays, when legislation is increasingly complex and even experts frequently fail to agree on its interpretation, such 'penalization' is all the more baffling. Moreover, the concept of the index does not provide for any redress mechanism in the event the court overturns a decision, such as if the court were to lean towards the taxable entity's view.

The counter-argument used that the taxable entity may apply for a stay of action and, if granted, penalty points are not assigned, is in my opinion untenable. The court is authorized to grant suspensory effect only if immediate execution or other legal consequences of the contested decision would threaten grave harm, substantial economic or financial damage, serious environmental damage or other serious irreparable harm, and if granting of suspensory effect is not contrary to the public interest. Thus, failure to grant suspensory effect has nothing to do with the likelihood of success in litigation. Even if the taxpayer subsequently successfully seeks redress in court proceedings, its name will remain 'tarnished', since the index has already listed it as an unreliable entity (albeit wrongly). If the decision is overturned by a court, the taxable entity may, theoretically, be entitled to compensation for the damage caused by the unlawful decision, but the claim process is complex and lengthy, and reputational damage is known to take a long time to repair.

VII. Notifications on the index do not include reasoning

Other notable drawbacks concern notifications, which are actually decisions on the assignment of the index. The notification of the tax reliability index assignment should, pursuant to Article 53d(1) of the Tax Code, include a recital describing the reasons for the determination of the index. The notifications available to me merely stated penalty points assigned and a very cursory description (in a few words, using a number of abbreviations) of what the penalty points were assigned for. Any calculation or information regarding the financial indicator were missing. In some cases, the respective taxable entities could not even identify the infringement for which the penalty points were assigned. In addition, the

notifications did not identify at all the benefits for which the taxable entity was assessed, as envisaged in the Explanatory Memorandum.[24]

Conclusion

Based on conversations with clients and colleagues, I regret to say that the foregoing list of drawbacks plaguing this concept of tax reliability index is not exhaustive. However, even the incomplete overview above demonstrates that the concept does not meet several standards for tax laws as defined by the Constitutional Court.

In conclusion, let me just say that I consider and have always considered the assignment of a tax reliability index a good idea and an effective means of motivating taxpayers to file and pay their taxes fairly. However, since the concept itself, when introduced, has fundamental deficiencies that go beyond the boundaries defined by the Constitution (in particular, elements of retroactivity and discrimination, non-compliance with the principle of legality), it cannot honestly be expected that taxpayers will accept it and that it will have the desired effects. One of the reasons may be the fact that the professional community could only comment on the rough outlines of the index concept during the comment procedure, because the concept as a whole became known only after posting relevant information on the TA website, which was not preceded by a public debate. In the light of the above deficiencies and in order to save the concept, it would be advisable to revise it and make it public only once the inconsistencies have been resolved. I would again point out that if the concept and relevant legislation (I mean in a comprehensive form and not just the wording of the Act and the Decree) had not been drafted in haste and had been sufficiently discussed with the professional community, most of the drawbacks could have been eliminated in the preparatory procedure.

24. “The notification shall indicate, in particular, the benefits for which the taxable entity qualified and what was considered in making that qualification.” Explanatory Memorandum, p. 32.