KempHoogstad
Tax Advice & Solutions

Švarsystem – KempHoogstad special, October 2024

Dear clients,

The so called “švarc system” existed, exists and will exist. It is a tool frequently used by many firms which basically represents “hidden employment” whereby the firms save money they would otherwise spend on social security and health insurance contributions. Also, the termination of such relationships is much easier because the Labour Code does not allow employers to end a person’s employment easily. There is a risk of tax and related fees being levied if the state administration assesses the relationship as not independent but fulfilling the characteristics of a dependent activity or employment.

What has changed in this area recently? How have court rulings responded to this type of cooperation? You will be pleasantly surprised: some of them have given companies a helping hand.

We will be happy to help you examine whether and to what extent this topic applies to you and how best to respond in a timely manner. We wish you a pleasant autumn and we look forward to working with you again if you have any questions.

Bohdana Pražská and the KempHoogstad Team

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Švarc system? What is new in this area?

Are your firm or clients affected by this?

The švarc system is an illegal activity that has the characteristics of dependent work and is carried out by a natural person outside the employment relationship.

The essence of švarc system is that a company hires a self-employed person instead of an employee for a position, but the self-employed person works for the company according to the company's instructions and, in most cases, performs work only for the company under predetermined conditions, in a relationship of superiority and subordination whereby work is carried out personally and on behalf of the employer for a predetermined remuneration –i.e. having parameters resembling an employment relationship.

The amendment to the law this summer has reopened this hot issue. At the same time, time has already brought a **number of very interesting court decisions** in this area. We would like to draw your attention to some of them.

Short review

Let us recall that for the purposes of taxation, **income from employment** is considered to be income from a current or previous employment relationship, where **the taxpayer is obliged to follow the orders of the payer** (the employer) when performing work for the payer. He is paid a salary in accordance with the Labour Code and is subject to the related social security and health insurance contributions.

By contrast, a **self-employed person** ("SEP") **is an independent person** who invoices the company for his services and is not subject to the regulations under the Labour Code and related regulations.

Specific court decisions

1) In the past it was believed that one of the specific features of the švarc system was the permanence of such relationships. One of the judgements concludes that **even business-to-business relationships can be of a permanent nature** because the market does not offer another suitable and reliable partner. The relationship can be mutually beneficial and advantageous and it does not necessarily mean that it constitutes a švarc system relationship.
2) Another interesting judgement deems that the state's efforts to increase employment **cannot create pressure** to close employment relationships unless there is a mutual interest in doing so.
3) Where the law allows for multiple contractual arrangements to be chosen in a given relationship and where the contract between the parties is clearly entered into on the basis of free will as to the superiority and subordination of the parties and the advantages and disadvantages (including the tax effects of such a relationship), restraint on the part of the state authorities as to the assessment of such a relationship is appropriate, says another interesting court judgment.
4) Seeking **to minimise costs and maximise profits** by having an entrepreneur carry out certain activities **under a works contract is a rational**, not a detrimental, decision-making element and serves a rational ordering of social relations, the Supreme Administrative Court ("SAC") has ruled.

5) The choice of **contractual relationship must not be made under pressure** on a party to the contract; rather, it must be the voluntary decision of the subject. If the reasons for the choice of independent activity are tax-optimising, then this fact does not mean that the procedure is illegitimate. At the same time, however, there must not be a pretence of independence in a purely dependent relationship and it must not constitute an abuse of the law, according to another interesting judgment of the Supreme Administrative Court.
6) Another judgment states that a person cannot be considered economically dependent if that person is able to earn an income elsewhere; if he or she were to end his or her long-term relationship with the "employer", then the essence of free enterprise is fulfilled. If the person does not have such an opportunity, the element of dependence of an employment relationship would be satisfied. The SAC adds that otherwise, essentially any activity that one entity carries out for another on the basis of the latter's requirements on a long-term basis could be regarded as a dependent activity, which would certainly be very simplistic.

Is there a risk of sanctions?

But what is the risk if the authorities assess the relationship as falling under the švarc system ? There is a risk of a fine of **up to CZK 10 million** (or at least CZK 50,000) being imposed. **The company may also be banned from operating for a maximum of two years**. Furthermore, there is a risk of an assessment for employment tax (including social security and health insurance contributions) and of the transfer of information between administrative authorities regarding possible tax and fee evasion. Furthermore, there is a risk of losing various public contributions and subsidies in the field of employment. Risks exist in the event of an industrial accident, of investment into or the sale of the company.

So how to assess whether the activity concerned should be considered a dependent activity or an independent business?

In particular, it should be assessed – in the light of the nature of the activity in question – whether the person carries it out independently, on his or her own account and responsibility.

Help: Do I treat other business partners in this way?

A self-employed person should be able to carry out his or her activities for multiple entities without the consent of the company. It is in everyone's interest to have multiple customers, although the company may be the main one.

There are some **activities** which are so **dependent by nature** or essence on the person to whom they are provided that the potential independence of the person providing them cannot be considered at all (saleswomen, secretaries, assistants, etc.). Such positions should not be filled by self-employed persons. There are also **activities** that **can be provided both by the self-employed and through dependent work** (e.g. programmers, sales representatives, consultants, experts, various freelancers and smaller trades).

In making a decision, it is necessary to assess not only which category the person falls into, but also the other features of the relationship between the parties. For example, relationships with self-employed persons are suspect if the same persons have previously worked for the same employer under an employment relationship.

Self-employed persons are not covered by the Labour Code, so all institutions that could resemble an employment relationship – such as working hours, holiday entitlement, attendance records, overtime payments, and travel allowances – should be eliminated.

A self-employed person should not be in the company's management, presented on the website with other employees, wear company clothing, have a company phone number or email address, or be allowed to work in the company's offices. He or she should carry out the activity in question at her own expense, and the company should not provide her with basic equipment (e.g. a computer). Otherwise, she would logically not be able to carry out his or her activities independently. An exception may be made for the rental of more expensive or specialised work equipment, which may be offset against invoicing for services. There is also a risk if the self-employed person participates in events with colleagues (such as team buildings and company training.

The remuneration should not be a lump sum (e.g. per month), but ideally for a complete job. The self-employed person should invoice as standard and charge VAT where applicable. The contract with the self-employed person should contain at least basic conditions for complaints and the removal of defects.

The risk is reduced if it is a specialised activity carried out on an intermittent or short-term basis. On the other hand, long-term and permanent relationships also arise between entrepreneurs. Thus, a relationship of a permanent nature does not preclude independent activity.

Conclusion

In conclusion, we stress out that it is not important how the relationship appears formally, but what its parameters are. What matters is the actual fulfilment of the conditions of the dependent activity. In doing so, the administrative authorities must prove that all the characteristics of dependent employment have been fulfilled. To this end, the supervisory authorities can ask the worker a set of well-targeted questions which will easily reveal the nature of the relationship (e.g. who assigns the work, who controls it, when and where it is carried out, etc.).

In the first half of 2024, about 10,000 employment inspections were carried out, fines of about CZK 250 million were imposed and breaches of employment rules were found in about half of the audited entities.

This issue needs to be examined especially within the context of holdings and groups, as well as in respect of different types of supplies and subcontracts.

We would be happy to share our experience with you in this area.

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