

Michal Radvan*

TAXATION OF BUSINESS INCOME IN THE CZECH REPUBLIC

1. INTRODUCTION

In the Czech Republic, the personal income tax is regulated together with the corporate income tax by an act called Income Taxes Act (Act no. 586/1992 Sb., as amended).¹ This Act lies down that the objects of taxation are the following types of income (no matter if it is a monetary or a non-monetary income or the income was acquired by exchange):

- Income from dependent activity (employment), incl. emoluments of office-holders (function benefits);

* Vice-dean for foreign and external affairs at the Faculty of Law, Masaryk University, Czech Republic, and Associate Professor of Financial Law at the Department of Financial Law and Economics.

¹ Vide for example I. Pařízková, M. Radvan, [in:] Radvan M. et al., *Finanční právo a finanční správa – Berní právo*, Brno: Masarykova univerzita et Doplněk, 2008; H. Marková, *Zákon o daních z příjmů. Komentář*, Praha: C.H. Beck, 2007; P. Mrkývka, *Opodatkowanie dochodu w Republice Czeskiej*, [in:] Etel L. (ed.). *Opodatkowanie dochodu w wybranych krajach Europy Środkowej i Wschodniej*, Białystok: Temida2, 2006, pp. 93–128; M. Radvan, *Tax Law as an Independent Branch of Law in Central and Eastern European Countries*, Lex Localis – Journal of Local Self-Government, Maribor, Graz, Trieste, Split: Institute for Local Self-Government and Public Procurement Maribor, 2014, vol. 12, no. 4, pp. 813–827. ISSN 1581-5374. doi:10.4335/12.4.813-827(2014), WoS: 000343688000004; M. Radvan, *System of Tax Law*, [in:] Radvan M. *System of Financial Law: System of Tax Law: Conference Proceedings*. 1, wyd. Brno: Masaryk University, Faculty of Law, 2015, pp. 18–28. WoS: 000379379800001.

- Income from independent (i.e. business other gainful) activity;
- Capital (property) income;
- Rental (lease) income;
- Other income.

Each of these incomes are described individually in Sections 6–10 of the Income Taxes Act and for each of these incomes it is necessary to calculate so called partial tax base and at the end every taxpayer must calculate these partial tax bases together to get the tax base.

In the following text I would like to point out the income tax paid by entrepreneurs in the Czechia and deal with the construction of the tax and especially the tax base. Entrepreneurs have a possibility to use so called lump sum expenses. The main goal of the article is to confirm or disprove the hypothesis that these lump sum expenses are extremely high compared to other countries. It will be necessary to describe legal regulation in this area *de lege lata* and to define strengths and weaknesses of up-to-date regulation. At the end I will try to draft proposals *de lege ferenda*. I dealt with this topic in my previous research several times,² and I am using the text from these publications in this paper, too. There is no adequate scientific literature in this area available in the Czech Republic.³

² M. Radvan, *Czech Tax Law*, 3rd ed. Brno: Masarykova univerzita, 2010, pp. 12–19; M. Radvan, *Lump Sum Expenses and Their Impact on Public Budgets in the Czech Republic*, [in:] *Бюджетные и налоговые реформы в странах Центральной и Восточной Европы*, Voronezh: Izdatelstvo Voronezskogo gosudarstvennogo univesiteta, 2011, pp. 37–42; M. Radvan, *S dokladem, nebo bez?*, [in:] *Dny práva 2012 – Days of Law 2012*; X. Část, *Veřejná finanční činnost – právní a ekonomické aspekty*, Brno: Masarykova univerzita, 2013, pp. 2272–2279; M. Radvan, *Income Taxation of Entrepreneurs in the Czech Republic. Krytyka prawa. Niezależne studia nad prawem*, Warszawa: Akademia Leona Koźmińskiego, 2013, vol. 5, no. 1. ISSN 2080-1084. doi:10.7206/kp.2080-1084.17, pp. 301–313. M. Radvan, P. Mrkývka, *The role of tax law jurisprudence*, [in:] Gliniecka J., Drywa A., Juchniewicz E., Sowiński T., *Prawo finansowe wobec wyzwań XXI wieku – The financial law towards challenges of the XXI century*, Warszawa: CeDeWu, 2015, pp. 429–436.

³ With the exemption of R. Boháč, *Paušální uplatňování daňových výdajů jako nástroj řešení hospodářské krize*, [in:] Papoušková Z. et al., *Finanční věda a finanční právo v prostředí hospodářské krize*, Olomouc: Vydavatelství Univerzity Palackého v Olomouci, 2010.

2. TAXPAYERS

There are two types of taxpayers liable to personal income tax:

- 1) Tax residents – natural persons with a residential address in the Czech Republic or individuals who usually stay in the Czech Republic (it means for at least 183 days in the relevant calendar year, either continuously or intermittently); these persons are liable to tax on income arising from sources in both the Czech Republic and abroad;
- 2) Tax non-residents – natural persons not mentioned above as tax residents, student from abroad or patients staying in the Czech Republic for the purpose of medical treatment; they are liable to tax on incomes arising only from sources in the Czech Republic.

3. OBJECT OF TAXATION

The object of taxation in case of business incomes is rather wide including incomes from agriculture production, forestry and fish farming, income from business (trade) and other commercial activities (for example experts, interpreters, arbitrators, bankruptcy trustees, etc.), i.e. all types of business according to Czech civil law. Moreover, shares of partners in profits of a general partnership and general partners' shares in profits of a limited partnership are taxed as incomes from independent activity, too. There are several possible incomes with no need of official registration or announcement to the public administration of such activities, such as the income from the use or provision of industrial or other intellectual property and from copyright, income from pursuit of an independent profession, and income from rent of business property; these incomes are taxed together with other incomes from independent (business) activity.

4. TAX BASE

Partial tax base from independent activity is created by the all above mentioned incomes reduced by the expenses incurred to generate, assure and maintain income specified in Section 24 of the Income Tax Act. If the taxpayer does not have enough expenses, he may claim **lump sum expenses**:

- 80% of the income from agricultural production, forestry and fish farming and from handicraft industry;

- 60% of the income from other industry and trades;
- 40% of the income from other business (for example lawyers, doctors, etc.) and other incomes like incomes from intellectual property, etc.;
- 30% of the income from rents of business property.

Lumps sum expenses, if used, include all the expenses of the taxpayer. In this case the taxpayer must keep an evidence of all his incomes. There is not a word on the evidence of expenditures, but in my opinion it must be kept as well because of the duty set in Section 7a of the Income Tax Act or in the Accounting Act.

The main problem of lump sum expenses is connected with their rate. At the beginning of the efficiency of the Income Tax Act (taxable period 1993) the rate of lump sum expenses was relatively low:

Table 1: Lump Sum Expenses Rates^a

Type of Income	by 2004 [%]	2005–2008 [%]	2009 [%]	2010	2011–nowadays [%]
Income from agricultural production, forestry and fish farming	50	80	80	80	80
Income from handicraft industry	25	60	80	80	80
Income from other industry and trades	25	40	60	40	60
Income from other business	25	40	60	40	40
Incomes from intellectual property	30	40	60	40	40
Other incomes	25	40	60	40	40
Rental Incomes	20	30	30	30	30

^a R. Boháč, *Paušální uplatňování daňových výdajů jako nástroj řešení hospodářské krize*, [in:] Papoušková, Z. et al., *Finanční věda a finanční právo v prostředí hospodářské krize*, Olomouc: Vydavatelství Univerzity Palackého v Olomouci, 2010, p. 142.

At the explanatory report to the Income Tax Act we can read that the main purposes of the lump sum expenses are practical aspects and

administrative simplification, not the tax relief.⁴ May be it could be right by the taxable period of 2004, but later the lump sum expenses have started to be more political than economic question and nowadays it is real tax relief for many taxpayers.

Even there were several amendments limiting the usage and the benefits of lump sum expenses, this institute is still overused and sometimes even misused. For example me as author of the textbook: I have no real expenses, but I have to tax only 60% of my income. Of course we can mention here many similar cases, where real expenses are far from the lump sum expenses. *De lege lata*, lump sum expenses can be used only if the maximum value of lump sum expenses does not exceed:

- 1.600.000 CZK in case of incomes from agricultural production, forestry and fish farming and from handicraft industry;
- 1.200.000 CZK in case of incomes from other industry and trades;
- 800.000 CZK in case of incomes from other business and other incomes like incomes from intellectual property, etc.;
- 600.000 CZK in case of incomes from rents of business property.

To be honest, this limitation is not applied in practice very often as small businessmen usually do not reach the income higher than 2 billion CZK. At least officially, because until November 2016⁵ there is no existence of a duty to issue tax bills in the Czechia.⁶ There is no legal obligation to issue a tax bill, unless the customer asks for one. But who really needs a tax bill for tax reasons? Employed persons have no possibility to deduct their expenses while calculating the tax and self-employed persons are usually using lump sum expenses and that is why they do not ask for tax bills, too. This practice leads to illegal reduction of taxable incomes and in the end to lower tax revenue. And unfortunately where is no plaintiff, there is no judge.

The other possibility to avoid the limitation of income is to use the spouse or children as the cooperative person(s).

⁴ Ibid.

⁵ For details on Electronic Revenue Registry see M. Radvan, J. Kappel, *Electronic Revenue Registry in the Czech Republic*, LeXonomica – Revija za pravo in ekonomijo, Journal of Law and Economics, Maribor: Univerza v Mariboru, 2015, vol. 7, no. 2, pp. 139–159. ISSN 1855-7147. doi:10.18690/18557147.7.2.139-159(2015).

⁶ M. Radvan, *S dokladem, nebo bez?*, [in:] *Dny práva 2012 – Days of Law 2012*, X. Část, *Veřejná finanční činnost – právní a ekonomické aspekty*, Brno: Masarykova univerzita, 2013, pp. 2272–2279.

Another limitation of lump sum expenses states that if the sum of partial tax bases where the lump sum expenses were applied (i.e. possibly income from independent activity and rental income) is higher than the sum of the other partial tax bases, it is not possible to apply tax reduction for a spouse living with the taxpayer in one household and tax preferences for children. In practice, it is quite easy to avoid this rule, especially if the taxpayer is employed in the same time, because of the construction of the partial tax base from dependent activity (gross wage + 34% of the gross wage as sums of social security insurance premium, contribution to the state employment policy and general health insurance premium that must be paid by the employer⁷). The other possibility is to use the spouse or children as the cooperative person(s) – they can use their own basic tax reduction instead.

In fact, the limitation of lump sum expenses impact on those businessmen who are single, childless, or if their spouse is on maternity leave. Moreover, these exemptions are creating several possible and legal, but different tax duties, and the taxpayer is forced to calculate the tax several times in different ways to find the best (i.e. lowest) tax duty.

As a problem I find different rates of lump sum expenses for different types of incomes, too. Let's have a look at two handicraft industries: mason and in-keeper. Mason sometimes has almost no real expenses; he is coming to the working place, where building material is prepared, bought by the investor. He needs just bricklayer tools (not very expensive and possible to use for a long time), working clothes, he may come by car ... What else? On the other hand in-keeper is paying rent, must buy all the products he is selling, etc.; his margin is usually at about 20%. It means that in case of in-keeper the lump sum expenses are set correctly, but the mason can save a lot of money while his tax is unfairly low. And we can give here many similar examples like car mechanics, chimney sweepers, plumbers, etc.

The above mentioned benefits of lump sum expenses are causing in other problem, in the Czechia known as Svarcssystem, what is the topic for the part on Taxation of Employment Income.⁸

⁷ See part on Taxation of Employment Income.

⁸ See also M. Radvan, *Income Taxation of Entrepreneurs in the Czech Republic. Krytyka prawa. Niezależne studia nad prawem*, Warszawa: Akademia Leona Koźmińskiego, 2013, vol. 5, no. 1. ISSN 2080-1084. doi:10.7206/kp.2080-1084.17, pp. 301–313.

I believe the number of entrepreneurs using lump sum expenses should be limited. There are several ways.⁹

- 1) An obligation to issue tax bills every time entrepreneur receives money for goods or services would lead to higher taxable incomes and higher expenditures shown in the accounting books;
- 2) The lump sum expenses should be lower in general and the maximum rate I can imagine to be effective for state is 50%;
- 3) There should be more differences between the types of incomes. There are many types of industries, but they all are defined and described in the appendix to the Trades Licensing Act¹⁰;
- 4) The lump sum expenses should be used only by those who are not the VAT payers. The VAT payer has a duty to keep accounting books and the reason for lump sum expenses using (lower requirements for the bookkeeping) is limited;

Every taxpayer using lump sum expenses should have at least one employee. This would lead to the reduction of so called Svarcsystem (even to reduce Svarcsystem only we only need more precious control of respective authorities) and to higher rate of employment.

5. TAX RATE

The basic tax rate is percentual of 15 % calculated from the reduced tax base.¹¹ Since 2013 so called special solidary surcharge is introduced. The base of this surcharge is computed as a positive difference between the sum of income included in the partial tax base from employment and in the partial tax base from independent activity and the average salary according to the Social Security Act multiplied by 48. The rate of this special surcharge is 7% from this base. It means that even the official personal income tax rate is percentual linear, on fact it is progressive taxation and it should be clearly stated in the act as one of the basic information for the taxpayers.

⁹ Ibid.

¹⁰ Act no. 455/1990 Sb., as amended.

¹¹ See below the definition of the reduced tax rate.

6. CORRECTION COMPONENTS

There are several **incomes** generally **not liable to personal income tax**. In case of business incomes, the income in the amount which the Czech Republic is bound to settle as satisfaction accorded by the European Court for Human Rights could be mentioned.¹²

Even though some other incomes are liable to tax, the taxpayer can use general **tax exemption** (they can be tax-exempt). There are a large number of exemptions, but no special exemptions only for business incomes.¹³

The tax base shall be reduced by so called **tax allowances** to get modified (reduced) tax base:

- The value of gifts donated for charitable purpose¹⁴ in case that the total value of gifts in the taxable periods does not exceed 2% of the tax base or 1.000 CZK and the total maximum allowable deduction is 15% of the tax base;
- Sum paid by taxpayer paying contributions to the state-contributory supplementary pension insurance scheme within the taxable period reduced by 12.000 CZK; the maximum amount is 12.000 CZK in one taxable period;
- Sum paid by taxpayer paying private life insurance premiums within the taxable period; the maximum amount is 12.000 CZK in one taxable period;
- The amount equal to the interest paid in the taxable period on a mortgage/loan;
- Remunerations for exams verifying the result of continuing education up to 10.000 CZK.

Besides tax allowances, the taxpayer can use **items deductible from the tax base**¹⁵ to reduce his tax base, too. The most important item deductible from the tax base is a tax loss which was recorded and assessed in five previous taxable periods. There is two other important deductible items:

- 100% (or even 110%) of costs for research and development;
- Limited cost for professional training of students.

¹² For detailed information see Section 3(4) Income Taxes Act.

¹³ For the whole list of exemptions see Section Income Taxes Act, and other provisions concerning tax exemption in this act, for example Section 10(3).

¹⁴ For details see Section 15 (1) Income Taxes Act.

¹⁵ For details see section 34 Income Taxes Act.

The tax can be reduced by the **tax reductions**. The following amounts are valid per year:

- 24.840 CZK for each taxpayer (so called basic tax reduction);
- 24.840 CZK for a spouse living with the taxpayer in one household (but the spouse's own income may not exceed 68.000 CZK in the taxable period), if the spouse is the holder of ZTP/P card, the amount is double;
- 2.520 CZK for the beneficiary of a disability pension (1st and 2nd grade of disability);
- 5.040 CZK for the beneficiary of a disability pension (3rd grade of disability);
- 16.140 CZK for the ZTP/P card holder (very handicapped person with a guide);
- 4.020 CZK for the student up to 26 years or Ph.D. student up to 28 years.

Other tax reductions can be used if the taxpayer employs disabled employees – 18.000 CZK for every disabled employee, and 60.000 CZK for every severely disabled employee. For each child in the kindergarten, the taxpayer can reduce his tax up to the costs paid to the kindergarten (max. limit is the minimum wage).

People with children living in their household have right to use so called **tax preferences for children**. For the first child one parent can deduct as the tax reduction an amount of 13.404 CZK in a year. For the second child the amount is 17.004 CZK and for the third and any other child 20.604 CZK. If the tax after this reduction would be in minus, the tax preference is divided into two parts: tax reduction up to zero tax and tax bonus. If the taxpayer is economically active, the **tax bonus** (up to 60.300 CZK) should be paid him back, i.e. s/he “receives taxes from state”!

Here is the formula how to calculate the tax duty:

Partial tax base § 6

+ **Partial tax base § 7**

+ Partial tax base § 8

+ Partial tax base § 9

+ Partial tax base § 10

Tax base

- Tax allowances and items deductible from the tax base

Modified tax base (rounded down to whole hundreds)

Tax brutto I (15% of the tax base + possible 7% as special solidary surcharge)

- Tax reductions

Tax brutto II ≥ 0

- Tax preferences for children

Tax netto / Tax bonus

- / + Advance tax payments / Tax bonuses

After payment / Over payment

To conclude *de lege lata* regulation of correction components, the system is relatively complicated; it is more political and economic or legal issue. At least, the negative tax (tax bonus) should be abolished.

7. TAX ADMINISTRATION

The **tax administrator** of personal income tax in general is the Financial Office determined by the residential address of the taxpayer. The taxpayer must submit his **tax return** before 1 April following expiry of the taxable period. If the tax return is prepared and submitted by the tax advisor or barrister, the tax return shall be filed latest six months following expiry of the taxable period (1 July) but before unextended due date expires (1 April), a power of attorney authorizing such representation must be submitted. In the tax return the taxpayer must state all necessary information relevant to the control of his tax duty and he himself must calculate the tax.

The tax must be **paid** within the same period, but there is a duty to pay advance payments. No tax advances are paid by taxpayers whose last known tax liability did not exceed 30,000 CZK and in some cases, if the taxpayer has incomes from dependent activity. In other cases the taxpayer is obliged to pay advance payments and their amount and frequency depends on the last known tax liability:

- Taxpayer with the last known tax liability between 30.000 CZK and 150.000 CZK must pay two advances in the amount of 40% by 15 June and 15 December;
- Taxpayer with the last known tax liability over 150.000 CZK must pay four advances in the amount of 25% by 15 March, 15 June, 15 September and 15 December.

The **revenue** from personal income tax is distributed between municipal budget, region budget and state budget.

8. CONCLUSION

As we can see, the legal regulation of taxation of business incomes in the Czech Republic is not perfect, and there are many issues to be amended. But it is necessary to add that taxes, and especially income taxes, are really very political issue. Regardless of this fact, I would propose to limit the number of partial tax bases. I do believe that three is enough:

- 1) Income from dependent activity (employment);
- 2) Income from independent (i.e. business other gainful) activity incl. rental income;
- 3) Other incomes incl. capital income.

Unfortunately, the hypothesis that the lump sum expenses in Czechia are extremely high compared to other countries was confirmed. I believe the number of entrepreneurs using lump sum expenses should be limited and above there are mentioned several ways how to do it (lower lump sum expenses, differences between the types of income, applicable only for non VAT payers, condition to have at least one employee). Czechia must immediately apply Electronic Revenue Registry for all taxpayers and an obligation to issue tax bills. The tax rate must be fairly stated as percentual progressive. The number of correction components, especially exemptions, must be much lower and applicable for all taxpayers, i.e. not connected with the possibilities to apply lump sum expenses what force taxpayers to calculate the tax several times to optimize their tax duty. Then the tax administration is cheap and effective, and the costs of taxpayers to pay their taxes are lower, too. Remember that tax administration and taxpayers have the same task: to pay taxes in time and according to law.

STRESZCZENIE

OPODATKOWANIE DOCHODU Z DZIAŁALNOŚCI GOSPODARCZEJ
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W tekście wskazuje się na podatek dochodowy płacony przez przedsiębiorców w Republice Czeskiej i zajmuje się konstrukcją podatku, a zwłaszcza podstawy opodatkowania. Przedsiębiorcy mają możliwość korzystania z tak zwanych kosztów ryczałtowych. Głównym celem artykułu jest potwierdzenie lub obalenie hipotezy, że te ryczałtowe wydatki są bardzo wysokie w porównaniu do innych krajów. Artykuł opisuje i analizuje prawne uregulowania w tym obszarze *de lege lata* i definiuje mocne i słabe strony aktualnego rozporządzenia. Na koniec proponowane są propozycje *de lege ferenda*.