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## TAXATION OF EMPLOYMENT INCOME IN THE CZECH REPUBLIC

### I. INTRODUCTION

As was already mentioned in the article on taxation of business income 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).<sup>1</sup> There are five types of incomes and one of them is the income from dependent activity (employment), incl. emoluments of office-holders (function benefits).

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<sup>1</sup> Vide for example I. Pařízková, M. Radvan, [in:] M. Radvan, 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:] L. Etel (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:] M. Radvan, *System of Financial Law: System of Tax Law: Conference Proceedings*, 1st ed., Brno: Masaryk University, Faculty of Law, 2015, pp. 18–28. WoS: 000379379800001.

In this text, i would like to point out the income tax paid by employees in the Czechia and deal with the construction of the tax and especially the tax base. Employees have to calculate their tax from so called super-gross wage, what is gross wage increased by social security premiums paid by the employer (additional 34% of the gross wage). The hypothesis to be confirmed or disproved as the main goal of the article is: the super-gross wage is a unique tax institute compared to other countries and should be abolished. As in the previous article, 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,<sup>2</sup> 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.

## 2. TAXPAYERS

There are two types of taxpayers liable to personal income tax: tax residents and tax non-residents. The criteria are the same as for those with business incomes.

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<sup>2</sup> M. Radvan, *Czech Tax Law*, 3rd ed. Brno: Masarykova univerzita, 2010, pp. 12–19; M. Radvan, P. Mrkývka, I. Pařízková, D. Šramková, *Labour Taxation in the Czech Republic*, [in:] *Gospodarka i finanse w warunkach globalizacji*, t. 1, wyd. 1, Toruń: Wyższa Szkoła Bankowa w Toruniu, 2008, pp. 453–465; 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, *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, J. Neckář, *Taxation of professional team sport athletes in the Czech Republic*, *Public Governance, Administration and Finances Law Review in the European Union and Central and Eastern Europe*, Budapest: Wolters Kluwer, 2016, vol. 1, no. 1, pp. 40–46. M. Radvan, P. Mrkývka, *The role of tax law jurisprudence*, [in:] J. Gliniecka, A. Drywa, E. Juchniewicz, T. Sowiński, *Prawo finansowe wobec wyzwań XXI wieku [The financial law towards challenges of the XXI century]*, Warszawa: CeDeWu, 2015, pp. 429–436.

### 3. OBJECT OF TAXATION

The object of taxation in case of employment incomes is rather wide. Basically it includes incomes from the recent or former labour relationship, service relationship or membership relationship or a similar relationship if the taxpayer – employee – must respect the payor’s – employer’s – commands in the course of execution of work for the payor.

Besides that incomes for work done by members of co-operatives, associates of limited liability companies and limited partners of limited partnerships, incomes for work of company liquidators, remunerations of members of statutory bodies of legal entities and incomes following in connection with recent, future or former execution of dependent activity or of function regardless of whether they follow from the payor for whom the taxpayer executes the dependent activity or function or from the payor for whom the taxpayer does not execute the dependent activity or function are considered to be the incomes from dependent activities.

Function benefits are taxed in the same way as incomes from dependent activity. Function benefits are defined as function salaries of members of the government, deputies and senators of the Parliament of the Czech Republic and salaries of chiefs of central authorities of the state administration and remunerations for execution of function in authorities of municipalities, in other authorities of territorial self-governance, state authorities, civic and professional associations, chambers and other authorities and institutions.

The income is even 1% (but not less than 1.000 CZK) of the input price of a motor vehicle in each month, if the employee can use it not only for business but for himself, too.

As it is obvious from the first paragraph of this section, incomes from dependent activities (as defined by Income Taxes Act) include not only incomes from labour relationships and the terms “employer” and “employee” must be explained in a broader sense than in labour law. There is a good reason for that: a different and higher taxation of employees than entrepreneurs.<sup>3</sup> That is why a lot of taxpayers are trying to become entrepreneurs, even if they must respect someone else’s commands in the course of execution of work. In Czechia this practice is called **Svarcsystem**. Mr. Svarc as a businessman was signing up employees, but even if they had to respect the Mr. Svarc’s commands in the course of execution of work for him, officially they were self-employed. This practice has never disappeared

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<sup>3</sup> See example below.

from the Czech economy, more over thanks to the advantages of lump sum expenses it is more often nowadays. This system offers even more benefits: the “employer” has no duty to pay social security premiums for his “employees” and they are cheaper than real employees. The “employee” can pay lower taxes and social security premiums, so he has no reason to fight with his “employer” for legal status.<sup>4</sup>

And we can see Svarcsystem even in the taxation of professional team sport **athletes** in Czechia.<sup>5</sup> Even though the activity of professional athletes, although not expressly excluded from entrepreneurship by the Trade Licensing Act, cannot be subordinated under permitted, professional or unqualified trade and neither is an independent profession, many athletes as well as sports clubs consider relations arising out of the so called professional contracts to be of self-employed nature and incomes arising out of these contracts are to be considered as incomes from self-employment. The basis for this opinion comes from a commonly known ruling of the Supreme Administrative Court from 2011.<sup>6</sup> In this case, the court examined the activity of a professional hockey player and concluded that

the activity of a professional athlete cannot be easily subordinated under “employment” in the sense of Labor Act. It cannot be therefore excluded, resp. considered illegal the conclusion of other than labor contracts between players and their clubs. It is disputable, whether it is necessary to interpret the term “employment” and forget to deal with the similar but tax term “employment”. This simplification then leads to a faulty conclusion of the court, which states: “... it is generally accepted in practice that professional athlete may – from a tax point of view – act as self-employed ... To divert from this generally accepted practice, there would have to exist a very strong reason based on for example an explicit change of the legal norms. Otherwise it is possible to argue by way of certain level of normative power of facticity.”

However, this conclusion is wrong because the fact that something is happening illegally for a longer period of time cannot mean that this behavior shall become in accordance with the law. I can only agree with the Supreme Administrative Court that the application of labor law to the area of legal relationships between clubs and players is difficult, if not in some cases (holiday, transfers etc.) impossible. In my opinion, whatever professional contract is concluded between the player and the club, it is always necessary

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<sup>4</sup> M. Radvan, *Income Taxation...*, pp. 301–313.

<sup>5</sup> More about this topic in M. Radvan, J. Neckář, *Taxation of professional...*, pp. 40–46.

<sup>6</sup> Ruling of the Supreme Administrative Court, Nov. 29, 2011, case no. 2 Afs 16/2011-78.

for the purpose of taxation of players' income in accordance with the principle of material justice to examine the contents of this relationship – rights and obligations of the parties. In most cases are these contracts concluded for a longer period of time (one to five years), the athlete (taxpayer) is obliged to follow orders of the club (employer, payor), s/he receives a fee for his performance, he cannot play for more than one club etc. The so called professional contracts of athletes in the area of team sports cumulatively fulfill all signs of relationships similar to employment and therefore should be taxed as income from employment. Shall the taxation of players' income from self-employment be accepted, disguised labor relationships made for the purpose of the unlawful lowering of tax burden would be de facto legalized.<sup>7</sup>

It shall also be stated that not all players' income necessarily comes from the club.<sup>8</sup> The player may have concluded other contracts for example sponsor contracts and this income would be usually taxed under income from self-employment. This is how it often works abroad, as Zika, the football agent states: "... the player receives some money from the employment agreement. And then he has another contract, for example a sponsor contract, and he receives much more money through this other contract."<sup>9</sup> It is apparent from the Spanish case with the Argentinian football player Messi, that even here should the financial administrative authority examine the content of the legal relationship for determining the income to the right partial legal base.<sup>10</sup> It would be appropriate to add that individual athletes (athletes in individual sports such as tennis players) tax their income under partial tax base from self-employment (given that they are not employed by the Ministry of Defense or Ministry of Internal Affairs), because apart from team players, they fulfill the conditions in Art. 7 of the Income Tax Act.

<sup>7</sup> A. Simpson, *Taxation of Non-Resident Entertainers and Sportsmen: The United Kingdom's Definition of Performance Income and How it Ought to be Measured* [online]. Washington University Global Studies Law Review. 2012, no. 11, pp. 693. [cit. July 10, 2014]. Available at [http://openscholarship.wustl.edu/law\\_globalstudies/vol11/iss3/5](http://openscholarship.wustl.edu/law_globalstudies/vol11/iss3/5).

<sup>8</sup> K. Tetlak, *Taxation of International Sportsmen*, Amsterdam: IBFD, 2014, pp. 11–17.

<sup>9</sup> L. Mádl, *Čeští páni fotbalisti, pozor! Platini vám provětrá peněženky*. *Aktualne.cz* [online]. Published 9.7.2013 [cit. 10.07.2014]. Available at: <http://sport.aktualne.cz/cesti-pani-fotbalisti-pozor-platini-vam-provetra-penezenky/r~cbfd0fe2e7f511e2ac07002590604f2e/>.

<sup>10</sup> ČTK. *Messi se vyplatí. 15 milionů eur jej zachrání před soudem*. *Aktualne.cz* [online]. Published June 27, 2013 [cit. 10.07.2014]. Available at: <http://sport.aktualne.cz/messi-se-vyplati-15-milionu-eur-jej-zachrani-pred-soudem/r~e29625f4df4e11e28518002590604f2e/>.

#### 4. TAX BASE

**Super gross wage** as a partial tax base from dependent activity (employment) is unique in the whole world. Super gross wage is a gross wage increased by 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 employer. If we accept the social security premiums (or at least social security insurance premium) as taxes, we can talk about tax on tax, i.e. double taxation. It must be mentioned that generally in other jurisdictions and historically in Czechia the tax base was constructed as the gross wage reduced by social security premiums. Very common is to lower the gross wage by lump sum expenses (as a percent or fixed amount) as the employees have some real expenses connected with their work (travelling costs, working clothes, etc.).

Above, I have mentioned Svarcssystem, and I will demonstrate the construction of the tax base on the example of mason with one child, with a gross wage of 300.000 CZK (approximately 12.000 EUR) per year:

##### A) Employed mason

Gross wage	300.000
+ Soc. sec. prem. (34% of gross wage)	102.000
<u>Tax base</u>	<u>402.000</u>

##### B) Self-employed mason

Income	300.000
- Lump sum expenses (80% of income)	-240.000
<u>Tax base</u>	<u>80.000</u>

As you can see, the tax base is almost five times higher for employed person. The construction of the tax base as a super gross wage is a real specific in Czechia, introduced in 2008, to save the revenue to the public budgets when progressive tax rate (12–32%) was replaced by linear tax rate (15%).

In Czechia, the pay as you go system (the withholding tax) is applied for income if the total amount does not exceed 10.000 CZK in the calendar month (no need to pay social security premiums), and an employee did not sign the tax declaration, i.e. he does not apply for the tax reductions and tax allowance for children. Usually it is used by the taxpayers in their second job. At the end of the year, there is no need to include this income in the tax return.

## 5. TAX RATE

The tax rate is the same as for those with business incomes. The basic tax rate is percentual of 15% calculated from the reduced tax base. Since 2013 so called special solidary surcharge of 7% is introduced.

Continuing in the example of the mason, we can see that the tax (tax *brutto* I) is still almost five times higher:

## A) Employed mason

Gross wage	300.000
+ Soc. sec. prem. (34% of gross wage)	102.000
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Tax base	402.000
Tax <i>brutto</i> I (15% of the tax base)	60.300

## B) Self-employed mason

Income	300.000
- Lump sum expenses (80% of income)	-240.000
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Tax base	80.000
Tax <i>brutto</i> I (15% of the tax base)	12.000

## 6. CORRECTION COMPONENTS

Besides **incomes** generally **not liable to personal income tax**, there are several incomes not liable to tax specific for employment incomes, for example reimbursement of travel expenses on business trips or the value of personal protective equipment, working clothes, etc.

The list of special **tax exemptions** of incomes from dependent activity includes *inter alia*:

- Sums spent by the employer in order to improve his employees' professional skills or for reskilling;
- Value of food and soft beverages given by the employer to the employees as a non-monetary performance;
- Non-monetary performance given by the employer to the employees from a fund of cultural and social needs or from the social fund;
- Privileges granted by the employer running public personal transportation to his employees and members of their families in the form of free or cheaper tickets;

- The employer's contribution to pension insurance and life insurance up to the sum of 50.000 CZK.

Until June 2016, retirement pensions were exempted from taxation under condition, that the taxpayer's incomes from dependent activity increased by partial tax bases from independent activity and rent do not exceed 840.000 CZK. Czech Constitutional Court decided<sup>11</sup> to abolish this limitation arguing the inequality of taxpayers. Well, this is a topic for a single article, and definitely to set a fix amount is not very good solution, on the other hand, Czech Constitutional Court yet again became a negative legislator.

The other correction components are very the same as applied by the self-employed taxpayers. The tax base shall be reduced by so-called **tax allowances** to get modified (reduced) tax base. Only one more tax allowance is to be added: the contributions paid by a member of a trade union organization up to 1,5% of the taxable income (the maximum amount is 3.000 CZK in one taxable period).

The tax can be reduced by the **tax reductions** as mentioned in the article on business incomes taxation. Concerning the basic tax reduction,<sup>12</sup> in an effort to reduce public deficits the legislator approved not to offer this basic tax reduction for taxpayers receiving on January 1 of the taxable period the retirement pension. This regulation was limited just for the fiscal years 2013 to 2015. For the taxpayer it was therefore crucial whether the taxpayer is receiving a retirement pension as at the beginning of the reporting period (1 January) or not. It was not the best solution to set a specific moment in time for assessing entitlement to a relief. On the other hand, in tax law it is quite usual to set a relevant date, even the taxable period is much longer (for example tax on immovable property). Several thousand pensioners therefore requested the suspension of payments of the retirement pension, many of them just for one day (1 January) to apply the basic tax relief. I do believe such a negotiation is the abuse of law. Czech Constitutional Court was dealing with the proposal from a group of senators to annul the legal text not allowing retired taxpayers to deduct basic tax relief.<sup>13</sup> And the court really granted this request arguing inequality between taxpayers who are in the tax period old age pensioners. But as it was mentioned above, it is very common in tax law to define a relevant date. Sometimes

<sup>11</sup> Finding of the Constitutional Court no. Pl. ÚS 18/15, dated June 28, 2016.

<sup>12</sup> M. Radvan, P. Mrkývka, *The role of tax law jurisprudence*, [in:] J. Gliniecka, A. Drywa, E. Juchniewicz, T. Sowiński, *op. cit.*, pp. 429–436.

<sup>13</sup> Finding of the Constitutional Court no. Pl. ÚS 31/13, dated July 10, 2014.

it is good for the taxpayer (for example right to deduct mortgage interests from the personal income tax base), sometimes not (described case). Such a relevant date makes tax law more flexible, easier, and cheaper for administration. The Court pointed out criterion on which the distinction between taxpayers receiving and not receiving the retirement pension is based, is purely formal and law also creates procedural opportunities for individuals to preserve both advantages (pension and tax relief). Especially in this case, Court had to deal with the abuse of law, but the judges used this argument to annul the legal text instead. Moreover, the Court stated that there is no relevant reason to create two groups of taxpayers with different rights. We must strongly disagree: The reason for the denial of the basic tax relief for pensioners should mean increased revenue for public funds. We can discuss this issue also from the ethical point of view, but pensioners are already receiving the pension from the state, and therefore they are not entitled to additional benefits, in this case the basic tax relief. Based on this jurisprudence of the Constitutional Court, the Czech Financial Administration decided not to apply the discussed provision in taxable periods 2014 and 2013. Individuals thus have several options how to (retroactively) apply for a basic tax relief in taxable period 2013: mostly by the employer or filing the supplementary tax return for the taxable year 2013. Only taxpayers currently under tax control will receive the basic tax relief automatically. In practice, it means that most of the taxpayers have no idea of any courts proceeding and its results, they do not follow any announcements by the Czech Financial Administration and if they properly followed the tax law in self-application and did not apply for the basic tax relief, they paid approx. 1.000 EUR more on taxes in the taxable period 2013. To summarize this case, the Constitutional Court did not ruled in this matter properly and it is not possible to accept the finding. It is always necessary to examine the reason why retired taxpayers requested to stop the payment of pensions. If the only reason was to reach the basic tax relief, it is an abuse of law. Conversely, if the taxpayer has another ambition (he wants to increase the retirement pension assessment), the abuse of law cannot act. Financial administration bodies should always examine why the taxpayer decided to particular behavior, in this case why the person receiving retirement pension decided to apply for the suspension of pension payment. Let us hope that similar decisions of the Constitutional Court are just rare exception to the rule of good and righteous decisions. I really do not want to see Czech Constitutional Court as a negative legislator.

Quite a new tax reduction allows the taxpayer to reduce his tax up to the costs paid to the **kindergarten** (max. limit is the minimum wage) for each child in the kindergarten.

People with children living in their household have right to use so called **tax preferences for children**. Details were described in the article on business incomes taxation.

Here is the finished example comparing the taxation of independent and dependent activities:

A) Employed mason

Gross wage	300.000
+ Soc. sec. prem. (34% of gross wage)	102.000
Tax base	402.000
– Tax allowances	–0
Modified tax base (rounded down)	402.000
Tax <i>brutto</i> I (15% of the tax base)	60.300
– Tax reductions	–24.840
Tax <i>brutto</i> II $\geq$ 0	35.460
– Tax preferences for one child	–13.404
<b>Tax <i>netto</i></b>	<b>22.056</b>

B) Self-employed mason

Income	300.000
– Lump sum expenses (80% of income)	–240.000
Tax base	80.000
– Tax allowances	–0
Modified tax base (rounded down)	80.000
Tax <i>brutto</i> I (15% of the tax base)	12.000
– Tax reductions	–24.840
Tax <i>brutto</i> II $\geq$ 0	0
– Tax preferences for one child <sup>14</sup>	–0
<b>Tax <i>netto</i></b>	<b>0</b>

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.

<sup>14</sup> Tax preferences for children can not be used as lump sum expenses were applied. On the other hand, the spouse can use tax preferences for children to lower the family taxation.

## 7. TAX ADMINISTRATION

Personal income tax on incomes from dependent activity is an advance payment tax (the employer as a payor submits the sum of deducted **advance tax payments** according to the Income Taxes Act until 20<sup>th</sup> each calendar month the latest, in which the duty of advance tax payment submission emerged). The tax base is the gross wage increased by 34% of social security premiums paid by the employer. No tax allowances can be used. The tax rate is percentual linear of 15% and the special solidarity surcharge of 7% is applied only for incomes higher than quadruple of average salary according to the Social Security Act. The next steps depend on whether the taxpayer signed so called statement. In this statement there are information for the employer about tax reductions and tax preferences; the employee can sign the statement only for one employer and if he does not do that, he has no right for tax reductions (with the exemption of “spouse” and “kindergarten” reduction) and tax preferences for children.

This is the formula for assessing the advance tax payment and net wage:

Gross wage

+ Soc. sec. prem. paid by employer (34% of gross wage)

Tax base (rounded up to whole hundreds)

Advance tax payment *brutto* I (15% of the tax base + possible 7% as special solidarity surcharge) of advance tax payment *netto* (if the statement was not signed)

- Tax reductions (1/12)

Advance tax payment *brutto* II  $\geq 0$

- Tax preferences for children

Advance tax payment *netto* / Tax bonus

Gross wage

- Soc. sec. prem. paid by employee (11% of gross wage)

- Advance tax payment / + Tax bonus

Net wage

During the year, the advance payments are calculated only by the employers and the employees do not have any tax duties at all.

Generally, 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 usually there is an over payment and it must be send to the taxpayer within 30 days after the tax return submission.

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  $\geq 0$

– Tax preferences for children

Tax netto / Tax bonus

– / + Advance tax payments / Tax bonuses

After payment / Over payment

Only if the taxpayer has incomes from one employer or consecutively from more employers and he has signed the tax statement(s), he does not have to submit his tax return declaration. In this situation, the employer prepares co called annual account of tax advances except the tax return. Possible over payments are transferred back to the taxpayer by the payor in his March wage.

The **tax administrator** of personal income tax in general is the Financial Office determined by the residential address of the taxpayer.

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

## 8. CONCLUSION

It is obvious that the legal regulation of taxation of employment incomes in the Czech Republic is not perfect. There are many issues to be amended, but, unfortunately and again, taxes are too political issue. As mentioned in the part on business incomes, I would propose to limit the number of partial tax bases. The nonsense called super gross wage must be abolished as soon as possible – the hypothesis was confirmed. The tax rate must be fairly stated as percentual progressive. The number of correction components, especially exemptions, must be much lower. But these are just the first steps, so that the tax administration is cheap and effective, and the costs of payors are lower, too.

## STRESZCZENIE

## OPODATKOWANIE DOCHODÓW Z PRACY W REPUBLICE CZESKIEJ

W tekście wskazuje się na podatek dochodowy płacony przez pracowników w Republice Czeskiej i zajmuje się budową podatku, a zwłaszcza podstawy opodatkowania. Pracownicy muszą obliczyć swój podatek od tak zwanego super-brutto wynagrodzenia, to jest płaca brutto powiększona o składki na ubezpieczenie społeczne płacone przez pracodawcę (dodatkowe 34% wynagrodzenia brutto). Hipotezę, którą należy potwierdzić lub potępić jako główny cel artykułu, jest: Super-brutto wynagrodzenie jest unikalnym instytucją podatkową w porównaniu z innymi krajami i powinno zostać zlikwidowane. Artykuł opisuje regulacje prawne w tym obszarze *de lege lata* i definiuje mocne i słabe strony aktualnego rozporządzenia. Na koniec proponowane są propozycje *de lege ferenda*.