

# ARTICLES

## THE CZECH INCOME TAX\*

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### 1. INTRODUCTION

On April 28, 1992, the Federal Assembly of the Czech and Slovak Federal Republic enacted the Act on Income Taxes ("Old Federal Act").<sup>1</sup> That statute was to become generally effective beginning January 1, 1993. Effective January 1, 1993, Czechoslovakia was divided into two separate sovereign nations, the Czech Republic and the Slovak Republic. On November 20, 1992, the Czech National Council passed its own Act on Income Taxes, generally effective January 1, 1993 ("Act").<sup>2</sup> The Act is essentially the text of the Old Federal Act with a few important modifications. The Slovak Republic continues to apply the Old Federal Act.

The Act sets forth only substantive tax law. All administrative provisions are the subject of separate legislation.<sup>3</sup>

This Article will discuss the normative objectives of simplicity, fairness, and even-handedness that should be accommodated when drafting and implementing a new tax regime. Although there are several significant sources of tax revenue in the Czech Republic (among others, the value added tax<sup>4</sup> and consumption taxes<sup>5</sup>), it is anticipated that the

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\* This Article reflects the law in effect as of November 30, 1993.

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<sup>1</sup> Č. 286/1992 Sb.

<sup>2</sup> See č. 586/1992 Sb [hereinafter Income Tax Act].

<sup>3</sup> See Act on the Administration and Collection of Taxes, č. 337/1992 Sb.

<sup>4</sup> See č. 222/1992 Sb. Value added taxes are expected to generate the second largest yield of revenues behind the personal and corporate income

combined individual and corporate income taxes will yield the most tax revenue. Accordingly, this Article will continue by providing a detailed description of the Act on Income Taxes with observations and commentary. Finally, this Article will submit an example of a viable structure for private U.S. investment in the Czech Republic and specify certain criteria for evaluating the efficacy of the Czech Republic's income tax legislation.

## 2. WRITING AN INCOME TAX CODE FOR A NEW MARKET BASED ECONOMY

The task of designing an income tax system on a clean slate is both intriguing and daunting. Still, advice is available from different quarters.<sup>6</sup> Above all, there seems to be a general consensus that in an emerging economy the drafters of a new tax code should strive to achieve a number of (sometimes competing) objectives.

### 2.1. *Simplicity*

Although simplicity is desirable in any tax system, it is particularly important for an emerging economy. Such economies tend to lack an adequate infrastructure, either at the taxpayer level or at the government level, to administer the tax law. Thus, a complex system that places complex compliance burdens on the citizenry is likely to engender both frustration and noncompliance. Without a trained bureaucracy, the ensuing lack of taxpayer-education and enforcement will result in lower levels of compliance. So too, in emerging economies where there are high levels of illiteracy, simplicity facilitates compliance. Fortunately, however, literacy rates are generally high in Eastern Europe and throughout the Czech Republic.

The most common device for simplifying the tax laws is to

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taxes.

<sup>5</sup> See č. 213/1992 Sb.

<sup>6</sup> See, e.g., WARD HUSSEY & DONALD LUBICK, BASIC WORLD TAX CODE (Harvard University International Tax Program 1992); Gordon, *Tax Administration Concerns in the Reform of Substantive Personal Income Tax Law in Emerging Economies*, 46 BULL. INT'L FISCAL DOCUMENTATION 163 (1992).

exclude certain potential taxpayers from the system by setting a sufficiently high taxable income threshold. For example, as noted below, the system of exemptions in effect under the Act removes from the tax rolls a family of four with one income earner and with annual income of not more than 50,400 crowns (about \$1,690).<sup>7</sup>

A second common device for simplifying the administration of the tax law is to collect the tax by some automatic mechanism such as withholding. In order to be truly simple, the tax collected by this means must be the total tax; this requires disregarding certain differences in various taxpayers' circumstances that might otherwise affect the amount of the tax. Although a withholding system does place considerable administrative burdens on the withholding agent (e.g., wage payer, dividend payer, etc.), these persons are far fewer in number, are far more sophisticated, and can more easily bear the cost of compliance.

Under the Czech system, there is a withholding tax on wages and salaries based on the amount of the wage or salary. This is not done at a fixed rate since the progressivity of the individual income tax is built into the withholding system.<sup>8</sup> Certain other facts about the taxpayer, such as the number of dependents (which affects the number of exemptions) are also taken into account. For example, there is a procedure whereby employees can certify to their employer that they have no other income and can thereby dispense with the obligation to file a return. Otherwise, individual, resident taxpayers generally must file returns.

The Act contains a number of provisions that tend to simplify both the determination and collection of tax, particularly for individuals. Some examples are:

- An exemption from tax for the gains from casual sale of certain personal property not used in business

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<sup>7</sup> Amounts in dollars are U.S. dollars. Conversion to crowns is at 29.87 crowns to the dollar, the commercial exchange rate for November 30, 1993, as quoted in the Wall Street Journal. *Currency Trading: Exchange Rates*, WALL ST. J., Mar. 1, 1994, at C16.

<sup>8</sup> The Act also imposes a withholding tax on certain types of income at flat rates between 15% and 25%. For a summary of these tax rates, see appendix.

(including stocks, bonds and ownership interests in cooperatives held for at least one year);<sup>9</sup>

- An exemption for gains realized on the sale of an apartment or other residential property (with no more than two residential units) if the taxpayer established a residence there at least two years prior to the sale. A similar exemption is available for income from the sale of other nonbusiness realty held for at least five years;<sup>10</sup>
- An automatic annual inclusion in an employee's income of 12% of the price of an employer provided automobile if the employee is allowed to use the car for personal purposes;<sup>11</sup>
- An exemption for various fringe benefits provided by employers such as meals, snacks and nonalcoholic beverages at the workplace, and use of the employer's recreational, health care, preschool, fitness, sports, and educational facilities;<sup>12</sup>
- Elective standard deductions for business and certain other dependent and rental activities of natural persons;<sup>13</sup> and
- An exemption for income not exceeding 6,000 crowns (about \$200) from occasional activities and occasional rental of personalty.<sup>14</sup>

Other important examples of generally-applicable simplification rules follow:

- There is no difference in rate between capital gains and other types of income;
- There is no inflation indexing for tax rates or asset basis;<sup>15</sup>

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<sup>9</sup> See *id.* § 4(c).

<sup>10</sup> *Id.* § 4(a)-(b).

<sup>11</sup> *Id.* § 6(6).

<sup>12</sup> *Id.* § 6(8)(b)-(d).

<sup>13</sup> *Id.* §§ 7(7), 9(3).

<sup>14</sup> *Id.* § 10(2)(a).

<sup>15</sup> Given the broad exemption for individuals' gains from the sale of moveable property (i.e., personal property), the lack of basis-indexing has less effect.

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- Certain payments made by Czech resident persons are considered to be Czech source income even if the income did not result from economic benefit within the Czech Republic;<sup>16</sup>
- Depreciation is based on tables that disregard the date (other than the year) in which the property is acquired;
- There is no integration whatsoever between corporate and shareholder taxes, no group relief, and no consolidated returns;
- There is no statutory system for credits against Czech tax for income taxes paid to foreign countries;<sup>17</sup>
- There is no system for deferring tax on property transfers during incorporation or during reorganizations of corporate structure;
- The partnership rules are very simple. For example, they require parallel treatment for both profits and losses;
- All taxpayers must use the calendar year as their taxable year; and
- The Act contains no rules for the income tax treatment of decedents' estates.<sup>18</sup>

On the other hand, the drafters' inability to resist grafting

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<sup>16</sup> *Id.* § 22(1)(d). For example, payments made by a Czech resident for the use of a copyright are Czech source income even if paid for use of the copyright outside the Republic. This royalty rule also operates, for example, under Paragraph 6(a) of Article 12 of the United States-Czech Republic Tax Treaty. Convention for the Avoidance of Double Taxation, Sept. 16, 1993, U.S.-Czech., art. 12(6)(a), T.I.A.S. No. 24,007, at 41 [hereinafter U.S./C.R. Treaty].

<sup>17</sup> However, section 39 empowers the Ministry of Finance to take measures to cause reciprocity. See Income Tax Act, *supra* note 2, § 39. It is not certain whether this will be done on a taxpayer by taxpayer basis or whether the Ministry will promulgate rules of general application on a country by country basis. In addition, section 37 states that international treaties to which the Republic is a party override the Act. *Id.* § 37. For example, Paragraph 2 of Article 24 of the U.S./C.R. Treaty provides for just such a credit. See U.S./C.R. Treaty, *supra* note 16, art. 24(2).

<sup>18</sup> At the present time, there may be no need to address the income taxation of decedents' estates since it is only recently that accumulation of substantial wealth would begin to necessitate the administration of complex estates. At least for now, property passes directly from the decedent to his heirs without the kind of hiatus that would require separate income

some social policy provisions into the revenue laws has resulted in added complexity.<sup>19</sup> Some examples are:

- The exemption from taxable income of income from certain environmentally friendly projects such as small hydroelectric plants and solar or wind powered facilities;<sup>20</sup>
- The deduction for contributions to charities and for other public good;<sup>21</sup>
- The standard deduction for an employee's commutation expenses;<sup>22</sup>
- The exemption for payments received from health care authorities by donors of blood and other "biological material";<sup>23</sup>
- At least seven different provisions giving special treatment to prizes and awards;<sup>24</sup>
- The elective accelerated depreciation;<sup>25</sup> and
- The tax credit for hiring the disabled.<sup>26</sup>

Another provision that only slightly simplifies the administration of the income tax system, while not easily justified on tax policy grounds, is the income exemption for benefits received from mandatory social, employment and

<sup>19</sup> Using the tax system to effect social and economic agendas is less efficient than direct subsidies and adds unwarranted complexity. On the other hand, direct subsidies are preferable because they better control the amount and duration of intended benefits. This is a basic precept of the concept of neutrality as discussed below.

<sup>20</sup> See Income Tax Act, *supra* note 2, §§ 4(e), 19(e).

<sup>21</sup> *Id.* §§ 15(8), 20(4). Since the contribution deductions have both a floor and a ceiling, they are additionally complex. Nevertheless, it may be good social or political policy to have both a floor and a ceiling.

<sup>22</sup> *Id.* § 6(12)(b). The employee is allowed a deduction of 200 crowns for each month of employment (if the employee works for at least five days in the calendar month) unless the worker's home address and the address of his regular place of work are the same.

<sup>23</sup> *Id.* § 4(j).

<sup>24</sup> *Id.* §§ 5(f), 10(1)(h), 10(1)(ch), 10(2)(b), 10(7), 10(8), 10(9), 36(2)(b). The reference to "ch" in the third citation in the preceding sentence is because, in the Czech alphabet, the ninth letter (between h and i) is pronounced "ch."

<sup>25</sup> *Id.* § 32.

<sup>26</sup> *Id.* § 35. This is a two tier credit that allows a greater credit for hiring

health insurance.<sup>27</sup> The resulting simplification is minimal since the large institutional payers of these benefits could easily withhold tax. Moreover, the exemption of these payments cannot be justified on the principle that they are merely a return of the recipient's own investment. Premiums paid by the employee are deductible in calculating taxable income.<sup>28</sup> As such, returns on investment are already taken into account. Moreover, employer paid premiums are specifically excluded from the employee's taxable income.<sup>29</sup> Without other explanation, given the large premiums and benefits involved under the Czech system of social welfare, the justification for exempting these benefits seems to lie in political expedience.

## 2.2. Fairness

The concept of fairness in taxation is obviously dependent on notions of economic and social philosophy and a tolerance for having one's own (or one's constituents') ox gored.

Probably the most important fairness issue in an income tax system is progressivity. Concepts of progressivity are based not only on the need to raise revenue from those most able to pay, but also on the social program of attempting to reduce disparities in disposable income. In any event, most income tax systems provide for a progressive system of tax rates as well as a system of credits, exemptions, or floors that remove the persons with the lowest income from the tax rolls.<sup>30</sup> Under the Czech system, the lowest bracket is taxed

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<sup>27</sup> *Id.* § 4(h).

<sup>28</sup> *Id.* § 26(12)(a). Section 7(4) allows a partner a reduction in his tax base for the mandatory premiums paid on social, health care and employment insurance. *See id.* § 7(4). This reduction is more valuable than a deduction since it applies even if the taxpayer claims the standard deduction under section 7(7). *See id.* § 7(7).

<sup>29</sup> *Id.* § 6(8)(e).

<sup>30</sup> As pointed out in the discussion of simplicity above, although progressivity adds complexity to the income tax statute, progressivity also simplifies tax administration by excluding from tax the lowest income individuals. The simplicity of administration results not only from the elimination of large numbers of people from the tax system, but also from the fact that the poorest people typically are the least competent to comply with the rules. Moreover, if the rates are fairly steeply progressive, the revenue that could be raised from these lowest income individuals would not justify the government's cost of administering such income tax.

at a 15% rate and the highest at 47%. Moreover, as pointed out above, a family of four with only one income earner pays no tax at all on the first 50,400 crowns. As a consequence, that family would pay only 9,000 crowns (about \$300) of tax on income of 110,400 crowns (about \$3,700).

Further, a taxpayer should not be penalized because the tax system, for administrative convenience, creates arbitrary tax periods. To ameliorate this problem, the Act allows the carry forward (but not carry back) of losses.<sup>31</sup> In addition, the Act provides a system of income-averaging for certain individuals who earn income over a shorter time span than the time span over which they expended the effort or cost to earn that income.<sup>32</sup>

Also, a taxpayer should not be taxed on income nominally earned if, as a result of other circumstances, the taxpayer's wealth does not increase. For example, if a taxpayer receives payment to compensate for a loss sustained, the payment should not constitute income. The Act grants to individual (but not corporate) taxpayers an exemption for compensation for damages and proceeds from property and liability insurance, except to the extent constituting compensation for loss of income.<sup>33</sup> Similarly, taxpayers should be allowed deductions for having sustained losses caused by natural disasters. A deduction for contributions made to charities and for other public purposes is usually justified on similar grounds because the taxpayer's net worth is diminished by the amount of such contributions. Accordingly, the Act provides deductions for both casualty losses and certain qualified contributions.<sup>34</sup>

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<sup>31</sup> Section 34(1) provides for a five-year carryover of losses. See *Income Tax Act*, *supra* note 2, § 34(1).

<sup>32</sup> *Id.* § 14. Unfortunately, the language of section 14 is confusing. It should be noted that since there is no progressivity in Czech corporate rates, there is no need to average corporate income since all positive net income will always be taxed at the highest rate.

<sup>33</sup> *Id.* § 4(d).

<sup>34</sup> See *supra* note 20 and accompanying text for a reference to the contribution deduction. The casualty loss deduction is found in section 24(2)(l). See *Income Tax Act*, *supra* note 2, § 24(2)(l). However, the deduction applies only to casualties resulting from natural causes, and, since it is listed under expenses incurred to achieve, secure and sustain income, it is possible that the deduction can be used only against related



### 2.3. Neutrality And Even-Handedness

The concept of neutrality in taxation is that a tax scheme should only be a method for collecting revenue, not a tool to manipulate taxpayer behavior. The concept of even-handedness is that all types of taxpayers should be taxed similarly on economically similar types of income. To a certain extent the two concepts are inextricably intertwined.

For example, a taxpayer should not be penalized because of the form of entity in which he chooses to hold property or conduct business. As discussed above, the Czech system fails in this respect since distributed corporate income is subject to double taxation.<sup>35</sup> Notwithstanding whether or not intended by the Act's drafters, it is possible to mitigate the effect of double taxation through the use of debt. Interest paid for business purposes is deductible by the corporation and, indeed, if this interest is paid on certain forms of securities, is taxed at only a 25% rate.<sup>36</sup> However, this stripping of earnings from a company is strictly circumscribed in the case of interest paid to related persons.<sup>37</sup>

Another principle of even-handedness is that foreign and domestic taxpayers should be treated the same. It is difficult to evaluate the Act in this regard since the Act, by its terms, is overridden by treaties to which the Republic is a party. Further, the Act grants to the Ministry of Finance the power to take measures in relation to foreign countries to achieve mutually balanced taxation.<sup>38</sup> However, one glaring example of a lack of even-handedness is that foreign lessors of property located in the Republic are subject to a 25% withholding tax on the gross rent without reduction for expenses, whereas

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<sup>35</sup> The disadvantages from a tax standpoint of doing business or owning property through a company are described more fully *infra* note 127.

<sup>36</sup> Section 36(2)(a) provides for the 25% rate on enumerated types of investment income, including income from securities. Income Tax Act, *supra* note 2, § 36(2)(a). However, the 25% rate does not apply to "interest . . . from credits and loans granted" as described in section 8(1)(c), which addresses interest on other forms of indebtedness. *Id.* § 8(1)(c).

<sup>37</sup> The rule that prevents earnings stripping through deductible interest payments to related persons was added when the language of the Old Federal Act was modified to become the language of the Act. The rule is further described *infra* note 174.

domestic taxpayers can deduct expenses.<sup>39</sup> Since the economic profit from rental is very often less than 25% of the gross rent, this tax as applied to foreigners is confiscatory.

On the other hand, the Act does not impose a tax on the payment of dividends by a company not domiciled in the Republic (even if it has a permanent establishment in the Republic) nor does it impose a tax on profits of the permanent establishment remitted to the home office. Thus, income earned by foreign owners of Czech companies is subjected to higher tax than the same income earned by foreign companies engaged in business within the Republic.

The withholding tax system provides some other less egregious, but certainly puzzling, examples of different taxation for economically similar types of income. Why should the interest on debentures be taxed at 25%, while the interest on a deposit account is taxed at 15%? Why should interest earned on an employee's deposits with his employer be taxed at 20%? One suspects that the answers do not lie in tax policy considerations.

### 3. ADMINISTRATION

In any tax system, the general level of compliance and successful collection of revenue has as much to do with the manner in which the system is administered as it does with the substantive provisions of the tax law.

The Czech bureaucracy for tax administration is disorganized, poorly trained, and not well informed as to the Ministry of Finance's official interpretation of the Act. So too, growing levels of entrepreneurship encourage government functionaries who develop some familiarity with the system to go into private practice, depriving the administrative authorities of some of their most knowledgeable people.

Issues of administration and procedure are way beyond the scope of this Article. However, the practicalities of dealing with the bureaucracy, especially in view of the many ambiguities and anomalies pointed out in this Article alone,

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<sup>39</sup> Note, however, that, for example, Paragraph 5 of Article 6 of the U.S./C.R. Treaty allows a U.S. resident taxpayer to compute its income from Czech real property on a net basis in determining its Czech income tax. U.S./C.R. Treaty, *supra* note 16, art. 6(5).

cannot be ignored. In Prague alone, there are eleven Financial Offices that administer the tax laws. It is said that if one asks the same question of each of the eleven offices one will receive eleven different answers (however, tax practitioners in countries with much older tax systems have often voiced a similar complaint).

The remainder of this Article is a detailed description of the Act (each subsection explores a specific section of the Act), together with some explanation of its operation and a number of related questions and observations, followed by a conclusion.

#### 4. TAX ON THE INCOME OF NATURAL PERSONS

##### 4.1. *Geographic Scope And Definition Of Residence*<sup>40</sup>

Czech resident individuals are taxed on their worldwide income; all others are taxed only on income from Czech sources. Nonresidents are taxed under special rates provided under section 36 of the Act.<sup>41</sup>

A person is a resident if present in the Czech Republic for at least 183 days in a calendar year (except for persons in the country for purposes of study or medical treatment).<sup>42</sup>

##### 4.2. *Definition Of Income*<sup>43</sup>

Income is broadly defined and specifically includes payments in kind. Nonmonetary income is valued using fair market value at the place and time of performance. The

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<sup>40</sup> See Income Tax Act, *supra* note 2, § 2.

<sup>41</sup> *Id.* § 36.

<sup>42</sup> There is a special rule in section 2(4) dealing with persons with income from dependent activities who enter the country daily or for an agreed time period for purposes of conducting such activities. Such persons are not treated as residents solely because of these brief interludes inside the country. Accordingly, income from these dependent activities may be taxed at a flat 25% rate, the rate applicable to a nonresident deriving Czech source income. *Id.* § 2(4).

Another special rule in section 2(5) causes foreign technical experts rendering dependent personal services to Czech companies on behalf of foreign entities to be taxed only on Czech source income even if the experts are present in the Czech Republic for 183 days or more. *Id.* § 2(5). Under section 6(12)(c), the tax base for these persons is then reduced by 30%. *Id.* § 6(12)(c).

statute specifically excludes from income the principal amounts of gifts, inheritances, and loans.

#### 4.3. Exemptions<sup>44</sup>

The act contains some unique exemptions from tax:

(a) sales of residential property with no more than two residential units, if the seller has lived there at least two years prior to the time of sale;<sup>45</sup>

(b) sales of other realty held for at least five years not used in business or the subject of a business;<sup>46</sup>

(c) sales of personalty. The exemption for personalty does not apply to proceeds from the sale of (i) motor vehicles, aircraft and vessels, (ii) bonds, and (iii) shares in companies or cooperatives owned for less than five years at the time of the disposition. Further, the exemption does not apply to income (as distinguished from gains) derived from capital as described in section 8<sup>47</sup> or to property used in business or as the subject of a business;<sup>48</sup>

(d) compensation for damages and proceeds from property and liability insurance, except to the extent constituting compensation for loss of income (this exemption certainly is not unique);<sup>49</sup>

(e) income from small hydroelectric plants (up to 1 MW)

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<sup>44</sup> *Id.* § 4.

<sup>45</sup> *Id.* This exemption is justifiable on simplification grounds. Without the exemption, there would be difficulties in policing compliance and, for the unsophisticated taxpayer, difficulties in tracking basis as improvements and other repairs that affect basis are made over the years. This suggests, however, a possible nontaxable occupation: a person can buy land, build a house on it, move in and then sell it two years later. He can start work on the second house before he has sold the first one, so that he can move into the second one as soon as he has sold the first, thus reducing to only two years the time between the tax free sale of the first house and the tax free sale of the second house. This could continue so long as the person was willing to keep changing residences.

<sup>46</sup> *Id.* Business property keeps its taint for five years after the tainting activity ceases. The taint cannot be avoided by a sale after the time period has passed if the sale is pursuant to an agreement entered into during the time period.

<sup>47</sup> Income Tax Act, *supra* note 2, § 8.

<sup>48</sup> Tangible property which is the subject of the taxpayer's business or used in the business continues not to qualify for the exemption until the expiration of a year from the termination of the activity.

<sup>49</sup> Income Tax Act, *supra* note 2, § 4.

and from environmentally friendly projects such as wind power stations, thermal pumps, solar equipment, equipment for the production of bio-gasses, equipment for the use of geothermal energy and equipment for the production of certain biodegradable materials. This exemption is available only to the initial owner, applies in the calendar year in which the project or equipment is brought into operation and the five following years, and is waivable. (Note the incentives created by this exemption),<sup>50</sup>

(f) awards not exceeding 10,000 crowns (about \$335) from public and sporting competitions, except for sporting competitions which are the subject of the taxpayer's business (thus, presumably, limiting the exemption for sports awards to amateur athletes);<sup>51</sup>

(g) a number of specifically listed public assistance stipends and benefits;<sup>52</sup>

(h) compensation from personal insurance policies with the exception of payments from endowment insurance exceeding the premiums paid;<sup>53</sup>

(i) fees paid to donors by the medical administration (but not by others) for blood and other biological material from the human body;<sup>54</sup> and

(j) certain payments for military reserve service and civilian service.<sup>55</sup>

#### 4.4. Tax Base<sup>56</sup>

The Czech tax is on net income. The tax base is the excess by which the gross income of the taxpayer in the calendar year<sup>57</sup> exceeds substantiated expenditures necessary to earn that income. In the case of a taxpayer who has two or more concurrent income sources during the tax period, the tax base

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> Income Tax Act, *supra* note 2, § 5.

<sup>57</sup> The Act often uses the term "tax period." However, it appears that the calendar year is the period for which the tax is levied.

is the total of the separate tax bases.<sup>58</sup> If expenses exceed the income from business and other gainful activity described in section 7 of the Act and from rental as described in section 9, the tax base is reduced by that loss.<sup>59</sup> If the loss cannot be used in the period in which it originated it may be carried over and deducted in the following tax periods, subject to a five year carryover limitation and other limitations in section 34.<sup>60</sup>

If a taxpayer does not use a double entry accounting system, business income received within 15 days before the beginning of the tax period to which it "belongs" in an accounting sense and within 15 days after the end of the period is considered to be included within that period. If income "belongs" to both one year and the following year, the taxpayer may choose to assign it between the two years.<sup>61</sup> The same rules apply to expenses. Hence, the Act reduces the opportunities for manipulating the timing of income.

#### 4.5. *Income From Dependent Activities And Emoluments Of Functionaries*<sup>62</sup>

Income from dependent activities consists of (i) income of employees<sup>63</sup> and income of high school and college students earned in practical training ("Wages from Employment"), (ii) income from work performed by cooperative members and partners of limited liability companies even if they are not obliged to comply with the orders of another party, and

<sup>58</sup> Query: what is the purpose of this rule? It is not to prevent losses from one activity from offsetting income from another activity since the Act specifically permits such offsetting in section 5(3). See *Income Tax Act*, *supra* note 2, § 5(3). One possibility is simply that in calculating the tax under section 16, the tax base, less deductions, is rounded down to the nearest 100 crowns. By preventing multiple tax bases, the Act prevents multiple rounding reductions.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* § 34.

<sup>61</sup> In addition, income from dependent activities (such as employment) and emoluments of functionaries (as described in section 6) received within 25 days after the end of the year to which they relate are deemed to be income in that earlier year.

<sup>62</sup> *Income Tax Act*, *supra* note 2, § 6.

<sup>63</sup> The statute defines employee status as a "relationship[] in which the taxpayer is obliged to comply with the instruction of the income payer while performing the work." *Id.* § 6(1)(a)

(iii) emoluments of members of statutory bodies<sup>64</sup> and other bodies of legal entities ("Emoluments").<sup>65</sup> The taxpayer receiving the income is referred to in the statute as "employee" and the payor as "employer."

Wages from Employment from Czech sources for a period not exceeding five calendar days per calendar month and not exceeding 3,000 crowns (approximately \$100) per calendar month constitutes a separate tax base subject to a special 10% rate.<sup>66</sup> Emoluments from Czech sources also constitutes a separate tax base subject to a special 20% rate.<sup>67</sup> In addition, Wages from Employment and Emoluments not exceeding 1,000 crowns per month are also subject to the special rate if the taxpayer does not claim tax free benefits (e.g., travel).

If the employer provides the employee with a motor vehicle for both official and personal use, the income of the employee includes 12% of the purchase price of the vehicle (or 1% for each month or fraction thereof, if less than a full year).<sup>68</sup>

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<sup>64</sup> Under the Commercial Code, the "bodies" of a limited liability company, for example, are the General Meeting, the Executives and the Supervisory Board if stipulated in the Memorandum of Association.

<sup>65</sup> The emoluments of a functionary are defined to be the official salaries related to offices held by members of the national government and deputies of the assembly; the salaries of heads of central administrative authorities; remuneration of functionaries in local administrative bodies; various other local authorities, civic and interest groups; and chambers and other bodies and institutions. Reimbursements to functionaries pursuant to regulation and in connection with official duties are not subject to tax; provided such reimbursements are not compensation for lost income.

<sup>66</sup> Section 36 sets forth this special rate. Income Tax Act, *supra* note 2, § 36. Section 6(12)(a) provides that in the case of these special Wages from Employment, there is excluded from the tax base social, employment, and health insurance which must be paid by the employee pursuant to separate legislation or decree. *Id.* §6(12)(a). If employees are subject to mandatory foreign insurance of the same type, the premiums on this foreign insurance are also excluded. Since the category refers only to income ensuing from sources in the Czech Republic, it is not clear how this foreign insurance would arise.

<sup>67</sup> *Id.* § 36.

<sup>68</sup> This seems to operate as a statutory presumption that if the employee is permitted to use the vehicle for personal purposes, substantial benefit accrues. This may be a rule of administrative convenience or a recognition that in a country where motor vehicles are not plentiful, the employee will indeed use the vehicle for personal purposes. Twelve percent per year is equivalent to a useful life of approximately eight years. This may reflect that Czech cars are long-lived or that the car is not used exclusively for personal purposes.

This rule applies to leased vehicles as well.

Reimbursement for travel expenses up to the amount determined under the Act on Reimbursement of Travel Expenses<sup>69</sup> is not subject to tax. The excess is taxable. Work clothing, uniforms and protective gear, and the maintenance thereof, provided by the employer are also exempt from tax.<sup>70</sup> So too, substantiated, reimbursed costs incurred on behalf of the employer are exempt.<sup>71</sup> In addition, a whole group of employer-provided benefits are also tax exempt:<sup>72</sup>

(a) training related to the employee's business (unless compensation for lost income);<sup>73</sup>

(b) meals and nonalcoholic beverages at the work place;<sup>74</sup>

(c) the use of recreational, health, education, sports or preschool facilities or company libraries or allowances for cultural or sports events;<sup>75</sup>

(d) mandatory insurance paid to the social insurance, health insurance and employment funds;<sup>76</sup>

(e) benefits in the form of free or reduced rate tickets provided by public transportation companies to their employees as well as their employees' families;<sup>77</sup>

(f) the bargain element resulting from an employee's acquiring shares for an amount below their nominal value pursuant to section 158 of the Commercial Code;<sup>78</sup> and

(g) "sweat equity" ownership interests in housing cooperatives given by the cooperative to their members to compensate them for construction work.<sup>79</sup>

<sup>69</sup> Č. 119/1992 Sb.

<sup>70</sup> Income Tax Act, *supra* note 2, § 6(7).

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* § 6(8).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* This in certain ways is analogous to the idea that the owner of a home does not realize income from his own work in improving the home. Note that under section 4(c), if the owner of the cooperative shares then sells them after holding them for more than one year, both the income and gain escape tax altogether. *Id.* § 4(c).



After determining the tax base for income from a dependent activity, it is reduced by:

(a) social employment and health insurance which must be paid by the employee pursuant to separate legislation or decree;<sup>80</sup> and

(b) 200 crowns (about \$7) for each calendar month during which work is performed if the employee carries on the work for more than five days in the calendar month, unless the employee's home address and the address of his regular place of work are the same.<sup>81</sup>

Wages and salaries are generally subject to withholding. The amount of withholding is calculated by the employer based on the amount of the compensation plus the information furnished by the employee with respect to any exclusions and exemptions under section 15.<sup>82</sup> However, unlike other forms of withholding under the Czech system, the withholding on income from dependent services is only a mechanism for collecting the tax. It is not the tax itself.

#### 4.6. *Income From Business Activities And Other Independent Gainful Activities*<sup>83</sup>

Income from business activities includes (i) income from forest and water management and agricultural production,<sup>84</sup> (ii) income from a "small trade," (iii) income from other authorized<sup>85</sup> business activities, and (iv) profit shares of partners in general commercial partnerships and of general partners in limited partnerships. Income from other gainful activities, unless included under income from dependent activities, includes (i) income from the use of, or provision of, industrial rights or other intellectual property, including

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<sup>80</sup> *Id.* § 6(12). It is not clear how this differs from the mandatory insurance referred to in paragraph (d) above. The statute also provides that the tax base is reduced by mandatory foreign insurance of the same type.

<sup>81</sup> *Id.* The purpose of this allowance is to compensate, at least in part, for commutation costs.

<sup>82</sup> Income Tax Act, *supra* note 2, § 15.

<sup>83</sup> *Id.* § 7.

<sup>84</sup> See Act on Citizens' Private Enterprise, č. 105/1990 Sb, § 12(a).

<sup>85</sup> Under the Czech legal system, regularly conducted businesses are required to be registered with various authorities.

copyright related rights<sup>86</sup> ("Intellectual Property") and (ii) income from the practice of independent professions or the performance of free lance occupations which are not a trade or business pursuant to separate rulings. Income from business and other independent activities that is not referred to in section 7 of the Act (generally because carried on only occasionally) is addressed in section 10.<sup>87</sup>

The tax base from this type of income is reduced by expenses incurred to achieve, ensure and sustain the income except in the case of profit shares of partners.<sup>88</sup> However, profit shares of partners are reduced by social, employment and health insurance premiums mandatorily paid by partners, unless the premiums are charged to costs of the partnership.

If a partnership sustains a loss, each partner takes his share of the loss, which reduces his tax base under section 5(3).<sup>89</sup> The statute provides that the loss is apportioned among the partners using the same allocation scheme relevant for income items.<sup>90</sup>

Up to 3,000 crowns of Czech-source intellectual property income<sup>91</sup> constitutes a separate tax base subject to a special 10% tax rate. Czech-source intellectual property income and income from the independent activities of lecturers, artists, athletes, entertainers, and accompanying persons who are not Czech residents is subject to a special 25% rate.<sup>92</sup>

The Act provides a system of elective standard deductions relating to independent activities that can be used instead of itemizing deductions. If the taxpayer does not claim expenses that can be proved to have been incurred to achieve, ensure

<sup>86</sup> This includes income from publishing, reproduction and distribution of literature and other works at the publisher's own expense.

<sup>87</sup> Income Tax Act, *supra* note 2, § 10.

<sup>88</sup> If an item is properly deductible to the partnership, it is reflected in the partnership's profit or loss; however, if it is not deductible to the partnership, it is not deductible at all, since the partners cannot deduct it.

<sup>89</sup> It seems that the losses of the partnership are deductible by the partners irrespective of the partners' basis in their interests in the partnership. It would make sense, for example, to limit the losses deductible by a limited partner to the cost of the partner's investment in his partnership interest.

<sup>90</sup> On its face, this suggests that a partnership agreement cannot provide for a different system of allocation of profits and losses.

<sup>91</sup> Per year? Per endeavor? Per endeavor per year?

<sup>92</sup> See Income Tax Act, *supra* note 2, § 36.

and sustain income, the taxpayer may claim as expense 50% of the income from agricultural production and forest and water management, 30% of the income from intellectual property (other than the amount up to 3,000 crowns subject to special treatment as described in the preceding paragraph) and 25% of the income from most other independent business and gainful activities.<sup>93</sup>

#### 4.7. *Income From Capital*<sup>94</sup>

“Income From Capital Assets” (hereinafter “Investment Income”), unless it is described under Income From Dependent Activities<sup>95</sup> or under Income From Business Activities and Other Independent Gainful Activities,<sup>96</sup> includes:

(a) profit shares (including dividends), interest and other distributions from securities,<sup>97</sup> participation in limited liability companies and limited partnerships,<sup>98</sup> and profit shares and similar distributions from membership in cooperatives;

(b) profit shares of silent partners;<sup>99</sup>

(c) interest and other gains from bank deposits and certificates;<sup>100</sup>

(d) other interest earned, and discounts on bills of

<sup>93</sup> Paragraph 8 of section 7 seems to provide that the taxpayer cannot cherry-pick the itemized/standard deduction decision from one activity to the other; rather, if the taxpayer elects the standard deduction, he must then use it for all income described in section 7. However, the language of paragraph 8 is far from clear. *Id.* § 7(8).

<sup>94</sup> *Id.* § 8.

<sup>95</sup> *Id.* § 6.

<sup>96</sup> *Id.* § 7.

<sup>97</sup> The term “securities” in Czech (literally meaning “precious papers”) refers to both debt and equity securities, including shares in companies.

<sup>98</sup> Since a general partner’s profit share from a limited partnership is included as income from business activity under section 7, it would seem that only limited partners’ shares are covered by section 8. *See* Income Tax Act, *supra* note 2, §§ 7, 8.

<sup>99</sup> *Id.* § 8. The profit share of a silent partner includable in income is reduced to the extent that the profits are used to restore a previously reduced investment by losses in that endeavor. Presumably the losses of silent partners are not deductible; otherwise there would be a double benefit to the losses.

exchange;<sup>101</sup>

(e) payments from endowment insurance policies and pension insurance policies outside the social insurance fund, reduced by the premiums;<sup>102</sup>

(f) the difference between the nominal value of securities<sup>103</sup> and the price paid upon their issuance (if a security is repurchased prematurely, the repurchase price, rather than the nominal value, is used to calculate the gain);<sup>104</sup> and

(g) income derived from the sale of the preemptive right for shares.<sup>105</sup>

Note that section 8 deals with current or periodical income from capital but not with the gain or loss from disposition of the capital asset itself.<sup>106</sup> Many such gains will be exempt under section 4.<sup>107</sup> Nonexempt gains are addressed in section 10.<sup>108</sup>

All of the foregoing Investment Income, with the exception of that described in paragraphs (d) (interest and discount) and (g) (income from sale of preemptive rights), if from Czech sources, constitutes a separate tax base subject to special rates<sup>109</sup> under section 36.<sup>110</sup> If not from Czech sources, it is aggregated with other income under section 5(2).<sup>111</sup> The income described in paragraphs (d) and (g) is included in the

<sup>101</sup> *Id.*

<sup>102</sup> Section 10(6) provides a system for recovery of the cost of the pension. See Income Tax Act, *supra* note 2, § 10(6).

<sup>103</sup> The term "securities" as used here seems to refer to something more like a debt security.

<sup>104</sup> Although the Act does not make it clear when this income is recognized, it is likely at that time is when the security matures or is redeemed. There seems to be no mechanism for recognition of an "original issue discount" while the taxpayer holds the security.

<sup>105</sup> Under Czech law, the organizational documents of a company can give various persons the right to buy shares.

<sup>106</sup> Income Tax Act, *supra* note 2, § 8.

<sup>107</sup> *Id.* § 4.

<sup>108</sup> *Id.* § 10.

<sup>109</sup> Most investment income is taxed at a 25% rate; however, income from passbook accounts, certificates of deposit and other deposit accounts is taxed at 15%.

<sup>110</sup> *Id.* § 36.

tax base without reduction for expenses.<sup>112</sup>

#### 4.8. Rental Income<sup>113</sup>

Rental income, unless described under sections 6, 7 or 8,<sup>114</sup> includes income from the lease of real estate, apartments, or a portion thereof, and income from the lease of personal property (other than the occasional lease of personalty, which is covered in section 10). In calculating the tax base, expenses to achieve, ensure and sustain the income are deductible. In lieu of itemizing expenses incurred, the taxpayer can take a 20% standard deduction. If the taxpayer claims the standard deduction, he cannot claim any other expenses relating to rental income.<sup>115</sup> Sections 23 to 34 are used to calculate the tax base.<sup>116</sup>

#### 4.9. Other Income<sup>117</sup>

Other income that involves any accretions of wealth, unless described in sections 4 through 9,<sup>118</sup> includes, but is not

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<sup>112</sup> It is not clear what social or economic policy makes these particular types of income subject to more burdensome taxation.

<sup>113</sup> See Income Tax Act, *supra* note 2, § 9.

<sup>114</sup> Although it is easy to imagine that some types of rental income could be included in business income under section 7 or in the income of a partner in a business under section 8, it is difficult to conceive of rental income that could be included in income from dependent activities under section 6. See *id.* §§ 6, 7, 8.

<sup>115</sup> If the taxpayer itemizes expenses, he must be able to document them. It is not clear whether the itemized/standard deduction choice can be made on an item by item basis or whether it must apply to all property rented by the taxpayer.

<sup>116</sup> Section 9(3) states that a nonresident individual is taxed at a special 25% rate on Czech source income from rental of personal property. Income Tax Act, *supra* note 2, § 9(3). However, section 36(1)(b) says that all income from leasing received by foreign individuals and companies is subject to 25% tax on gross rent. *Id.* § 36(1)(b). Thus, the function of section 9(3) is not clear.

Note that tax treaties may mitigate the effect of this tax on gross income which tax may actually exceed the net rental income. For example, Paragraph 5 of Article 6 of the U.S./C.R. Treaty allows a U.S. resident taxpayer to compute its income from Czech real property on a net basis in determining its Czech income tax. See U.S./C.R. Treaty, *supra* note 16, art. 6(5).

<sup>117</sup> See Income Tax Act, *supra* note 2, § 10.

limited to:

(a) income from occasional activities (including individual farming) or the occasional lease of personal property, but only to the extent that the overall amount of such income exceeds 6,000 crowns (about \$200) per year;<sup>119</sup>

(b) gains from the sale of a taxpayer's own real estate or personal property, including securities, except as exempted under section 4.<sup>120</sup> The statute contains a set of basis rules that are used to measure the amount of such gain;<sup>121</sup>

(c) gains (over the original investment<sup>122</sup>) from the

<sup>119</sup> Occasional income of this type is exempt up to 6,000 crowns per taxable period. In view of this low threshold (under \$200), this may be a rule of administrative convenience that recognizes the difficulty of enforcing on small amounts of occasional income. Moreover, an emerging economy might wish to encourage small enterprise of this sort.

<sup>120</sup> Section 4 exempts gains from certain residential and certain nonbusiness real estate and gains from many types of personal property, including securities, held for at least one year. See Income Tax Act, *supra* note 2, § 4.

<sup>121</sup> These basis rules apply only to gains from property of the type described in the text of paragraph (b). The basis is generally cost, which must be proven by the taxpayer in the same way that expenses must be proven. In the case of property received by gift or inheritance, the basis is the same as the value used for determining the gift or inheritance tax. If the property is acquired by barter, it is assumed that the value of the property is the price customary at the place and time of its acquisition. Basis also includes any amount evidently incurred for repair and maintenance or for other value added to the property. However, the value added by the owner's work in making or improving the property does not add to the basis. See *id.* § 10(4).

<sup>122</sup> In measuring the gain from transfers of interests in limited liability companies or cooperatives, upon liquidation of a partnership or a cooperative or the withdrawal of a member from a partnership or a cooperative, the basis must be determined. The basis is generally the cost of the investment in the entity.

If someone's capital investment is in the form of a contribution to the entity of real estate constructed or acquired less than two years from the time of its contribution, then the adjusted basis of the contributed property is the basis of the interest in the entity. The operation of this rule is unclear since there seems to be nothing (other than the exemptions in section 4 for gain on the disposition of a personal residence occupied for at least two years or of other nonbusiness realty held for at least five years) preventing the taxation of the gain on the exchange of the real estate for the interest in the entity.

A special rule applies to cooperative shares acquired through "transformation" of the cooperative or as compensation; but, the language of the Act is unclear. The rule seems to be that if a person has an interest in a cooperative, the cost of that interest continues after the cooperative is reorganized. However, property received as restitution cannot be added to

transfer of interests in a limited liability company or income from the participation in the basic equity of a cooperative, except as exempted under section 4;<sup>123</sup>

(d) income derived from inherited industrial rights and other intellectual property, including copyrights and other copyright related rights;<sup>124</sup>

(e) alimony, pensions<sup>125</sup> and similar continuous benefits, except as exempted in section 4;<sup>126</sup>

(f) the liquidation surplus of partners in a partnership or the liquidation surplus of cooperative members during the liquidation of the partnership or cooperative, and "settlement shares" upon termination of a partner's participation in a partnership or upon termination of membership in a cooperative reduced by the original investment (basis);<sup>127</sup>

(g) winnings in lotteries, stakes or similar games (except for those operated based on a permit issued pursuant to separate legislation or decree) and winnings from advertising contests and drawings; and

(h) awards from public<sup>128</sup> competitions and sports

cost.

<sup>123</sup> Section 4 has a special exemption for income from the transfer of ownership interests in business entities and shares of the fixed assets of cooperatives if the period between acquisition and transfer exceeds one year. See Income Tax Act, *supra* note 2, § 4.

<sup>124</sup> Note that under section 7(2)(a), income from business activities and other independent gainful activities includes "income from the use of or provision of industrial rights or other intellectual property including copyright related rights." *Id.* § 7(2)(a). A person receiving such income is entitled to claim the 30% standard deduction under section 7(7)(b). *Id.* § 7(7)(b). However, if the rights are inherited, only expenses that can be documented under section 10(3) are deductible. *Id.*

<sup>125</sup> In the case of pensions pursuant to section 842 of the Civil Code, the taxpayer is allowed to reduce the amount of pension income by amortizing the acquisition price evenly over the taxpayer's remaining life expectancy (based on average life expectancy as published by statistical bodies).

<sup>126</sup> A number of types of pensions are exempt under section 4. See Income Tax Act, *supra* note 2, § 4.

<sup>127</sup> See *supra* note 121.

<sup>128</sup> Awards from competitions where the number of competitors is restricted by the rules of the competition or the competitors are selected by the organizer of the competition are treated like awards from public competitions. However, if the overall sum of the awards won by a single competitor exceeds 20,000 crowns, the award is treated as income from independent activities under section 7. See Income Tax Act, *supra* note 2,

competitions, except as exempted under section 4.<sup>129</sup>

Payments received from installment sales of property are included in income as received. Costs relating to the property can be deducted only to the extent of the first installment and are then carried forward to the extent of future installments. A deposit received under a contract for the future sale of real estate is also taxed when received.<sup>130</sup>

The tax base for "other income" is the income reduced by those expenses that are documented as having been incurred to realize the income.<sup>131</sup> No standard deduction is provided. If the expenses relating to a particular type of income should exceed the income, the loss is not allowed. Winnings from Czech sources in lotteries, stakes or similar games, and from public and sports competitions constitute a separate tax base taxable at a special 20% tax rate under section 36.<sup>132</sup> If a public competition award includes remuneration for the use of artworks or performance, the tax base subject to the special rate is reduced by that remuneration which is included in income from independent activities under section 7. Winnings from foreign sources are aggregated with other income under section 5.<sup>133</sup>

<sup>129</sup> The section 4 exemption is limited to awards not exceeding 10,000 crowns and does not apply to sports competitions that are the subject of the taxpayer's business. In the case of a taxpayer whose business includes sporting activities, the awards from public competitions and sporting competitions are considered income from independent activities under section 7.

<sup>130</sup> The rules relating to installments and deposits are somewhat anomalous; nevertheless, at least, they are consistent with each other in that they tend to accelerate both income and cost recovery. Costs seem to be deductible immediately (up to the amount of the installments) rather than ratably over all of the installments. Deposits seem to be taxable when received even if they are refundable.

<sup>131</sup> If the income is from agriculture (but not by an independent farmer pursuant to the Act on Citizens' Private Enterprise, *supra* note 84), the 50% standard deduction of section 7(7)(a) can be claimed.

No deductions are permitted with respect to winnings in lotteries, games, drawings and advertising contests and sports and public competitions.

<sup>132</sup> Income Tax Act, *supra* note 2, § 36.

<sup>133</sup> *Id.*, § 5.



#### 4.10. Co-Owners<sup>134</sup>

Section 11 of the Act specifically provides that income and expenses of co-owners are allocated between the owners in proportion to their ownership interests.

#### 4.11. Income Of Association Members<sup>135</sup>

Income and expenses of persons in joint business activities or other gainful joint activities pursuant to an association agreement are allocated as provided in the agreement or, if not so provided, are divided equally. If the taxpayers in the activities share a joint household, the income and expenses are divided according to the taxpayers' "shares" in the joint income, but income may not be allocated to children of obligatory school age (including the calendar year in which school attendance is completed) or to a spouse if these persons are claimed as dependents.<sup>136</sup> No more than 20% of the income can be allocated to anyone other than the principal operator of the business activity.<sup>137</sup>

#### 4.12. Partners In General Commercial Partnerships And Partners In Limited Partnerships<sup>138</sup>

The tax base of a general commercial partnership is divided among the partners based on the partners' shares as provided in the partnership agreement. Losses are divided similarly.<sup>139</sup> Charitable contributions and other contributions for the common weal<sup>140</sup> are similarly divided between the partners, rather than being deducted by the

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<sup>134</sup> *Id.* § 11.

<sup>135</sup> *Id.* § 12.

<sup>136</sup> *Id.*

<sup>137</sup> This 20% limitation can be avoided by forming an association and then allocating income under the association agreement.

<sup>138</sup> See Income Tax Act, *supra* note 2, § 13.

<sup>139</sup> The requirement in section 13(1) that losses shall be shared in the same manner as income may have the effect of preventing a different allocation of losses than of income. On the other hand, it may be possible to define the partners' interests in the partnership agreement so that profits and losses are shared differently.

<sup>140</sup> Contributions for particular public purposes are allowed as a deduction pursuant to section 20(4). Income Tax Act, *supra* note 2, § 20(4).

partnership in determining the tax base that is subsequently divided among the partners. As such, the contribution deduction thresholds and limitations operate at the partner level, not at the partnership level.

Unlike a general commercial partnership, which is entirely a tax conduit, a limited partnership is a taxable entity that is taxed on income that is not allocated to its partners. The income and losses of the limited partnership, to the extent allocated to the partners pursuant to the partnership agreement, becomes part of each partner's taxable income. The remainder is the tax base of the limited partnership. Contributions are similarly allocated among the partners with the remainder being allocated to the limited partnership.

#### 4.13. *Income Averaging*<sup>141</sup>

There is a special income averaging rule available to certain limited categories of income typically earned by persons who work on a project for a number of years and then have that project bear fruit in a shorter time period. This income is (i) income from agricultural production and from forest and water related businesses, (ii) income<sup>142</sup> from intellectual property, including publishing and other copyright related rights, and (iii) income from restoring cultural monuments and collectibles.

Given the very limited application of the rule and the very confusing manner in which it is articulated, it will not be discussed further.

#### 4.14. *Exclusions And Exemptions*<sup>143</sup>

The tax base is reduced by the following amounts:

- (a) 20,400 crowns annually per taxpayer;<sup>144</sup>
- (b) 9,000 crowns annually for each dependent child (up to

<sup>141</sup> *Id.* § 14.

<sup>142</sup> The formal enumeration of the types of income is found in section 7(2)(a). *Id.* § 7(2)(a).

<sup>143</sup> *See id.* § 15. Under these exemptions, a family of four persons with one income earner would not pay tax until their income exceeded 50,400 crowns (approximately \$1,800).

<sup>144</sup> *Id.* § 15(1).

four<sup>145</sup> children) living in the taxpayer's household;<sup>146</sup>

(c) 12,000 crowns annually for a spouse living in the taxpayer's household unless the spouse has his or her own income exceeding 20,400 crowns annually;<sup>147</sup> and

(d) 6,000 crowns annually if the taxpayer is partially disabled, 12,000 crowns if the taxpayer is fully disabled and 36,000 crowns if the taxpayer holds a card indicating that the taxpayer is severely disabled and requires an escort;<sup>148</sup>

The basic 20,400 crown allowance is reduced (but not below zero) by one crown for each crown of retirement pension that the taxpayer receives. This rule does not apply in the year in which the taxpayer's pension begins. Although, nonresidents of the Czech Republic are not entitled to the basic 20,400 crown allowance, they are entitled to the remaining exclusions and exemptions.<sup>149</sup>

Under the Act, a "child" includes adopted and foster children of the taxpayer. Further, to be a "dependent" a child must be either an infant<sup>150</sup> or not more than 26 years old and systematically engaged in vocational study or training necessary to prepare for an occupation.<sup>151</sup>

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<sup>145</sup> The limitation to four dependent children might reflect a social policy on family size. In view of the limited ability of the government to verify reliably the number of dependents, the limitation to four dependents might also reflect the idea of the Act's drafters as to the maximum tolerable revenue loss per family that should be suffered by the fisc. For example, if a taxpayer wanted to claim his dog as a dependent, there is still an absolute maximum on the number of dogs that can be claimed by the taxpayer.

<sup>146</sup> Income Tax Act, *supra* note 2, § 15(1). The Act provides that temporary residence by the child outside the household does not affect the reduction.

<sup>147</sup> *Id.* For this purpose, income does not include (i) any increase in pension because of the recipient's immobility, (ii) parental benefits, child benefits, special benefits for foster parents, and (iii) allowances and scholarships for full time students in studies relating to their future occupation.

<sup>148</sup> *Id.* Disability allowances can be claimed concurrently with an old age, disability or partial disability pension.

<sup>149</sup> The statute refers to the amounts in subparagraphs (b) through (e) of section 15, paragraph (1). However, there is no subparagraph (e). See Income Tax Act, *supra* note 2, § 15(1).

<sup>150</sup> Generally under Czech law a minor is a person under the age of 18.

<sup>151</sup> A person under 27 years old can also qualify if the person is unable to prepare for a future occupation or be employed due to an illness or is unable to prepare under exceptional conditions due to a long term health condition.

If an adult child gets married and lives in the same household with his or her spouse, the spouse can claim the 12,000 crown allowance or, if the spouse has no<sup>152</sup> income to which the deduction can be applied, the parent of the child can claim the 9,000 crown allowance.<sup>153</sup>

If two parents provide for a child's support, only one of them can claim the child as a dependent for tax purposes. Alternatively, they can divide the allowance by twelfths (by month).

If a taxpayer meets the conditions for a deduction for less than a full year, the taxpayer can take one-twelfth of the deduction for each calendar month when the conditions were met.<sup>154</sup> A child may be declared by the taxpayer beginning in the calendar month in which the child is born.

Next, the tax base is also reduced by certain contributions. To qualify, they must be paid to municipalities or legal entities with headquarters in the Czech Republic to finance education and educational institutions, culture, fire-fighting, the support and protection of youth, social care, medical care, environmental, humanitarian and charitable purposes, religious purposes for churches and religious associations recognized by the state; for physical training and sports clubs; and for protection of abandoned animals and endangered animal species. Contributions are not deductible unless<sup>155</sup> they exceed 2% of the tax base or 1,000 crowns. Not more than 10% of the tax base can be deducted.

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<sup>152</sup> If the spouse has some income but the income is insufficient to be able to use the 12,000 crown deduction, it may nevertheless be that the parent cannot claim the 9,000 crown deduction since the Act seems to require that the spouse have "no" income to which the deduction can be applied.

<sup>153</sup> The statute also provides that the 9,000 crown deduction may be taken by a non-parent taxpayer who "substitutes the parental care" if the child (and, presumably the child's spouse) lives with the taxpayer in the same household. This seems to be a relaxation of the requirement that the dependent be a "child" (natural, adopted or foster) of the taxpayer.

<sup>154</sup> Must the conditions be met for the entire month? The rule that states that a child can be claimed from the month during which it is born suggests that the conditions need not be met for the entire month.

<sup>155</sup> It would be more logical to allow the deduction to the extent that the contribution exceeds the floor. However, under the wording of the Act, the contribution is deductible only if it exceeds the floor. Therefore, there is the inapposite result that a 1000 crown contribution may be totally nondeductible whereas a 1001 crown contribution would be totally

#### 4.15. Tax Rates<sup>156</sup>

The tax base as determined above is rounded down to the nearest hundreds of crowns and taxed at graduated rates. There are six tax brackets subject to rates from 15% to 47%.<sup>157</sup>

### 5. TAX ON INCOME OF LEGAL PERSONS<sup>158</sup>

#### 5.1. Taxpayers Liable For The Corporate Income Tax<sup>159</sup>

The corporate income tax applies to legal persons other than general commercial partnerships.<sup>160</sup> Thus a limited partnership is taxed in the same way as a corporation with respect to the income remaining after allocation to the limited partners.<sup>161</sup> References to corporations or companies will

<sup>156</sup> See Income Tax Act, *supra* note 2, § 16.

<sup>157</sup> The tax base up to 60,000 crowns is taxed at a rate of 15%. The remaining brackets are as follows:

<u>Tax Base Between</u>		<u>Tax Is</u>	<u>Plus</u>	<u>On Excess Over</u>
60,000	120,000	9,000	20%	60,000
120,000	180,000	21,000	25%	120,000
180,000	540,000	36,000	32%	180,000
540,000	1,080,000	51,000	40%	540,000
1,080,000		367,000	47%	1,080,000

*Id.*

<sup>158</sup> The whole system of company taxation under the Act makes it costly to do business in corporate form. This may be a deliberate decision since the burden of the corporate income tax will generally fall on foreigners doing business in the Czech Republic or on large (probably privatized) corporate entities. Some of these increased costs are: (i) the top corporate rate is 45%, which is higher than all but the highest individual bracket; (ii) dividends paid are not deductible to the paying corporation; (iii) there is no system of group relief enabling the current offset of the profits of one member against the losses of another; (iv) although dividends received by either an individual or a corporation are taxed at a special 25% rate, there is full double taxation at that rate; and, consequently, (v) if a parent receives a dividend from a subsidiary, there is then triple taxation. It is especially inefficient to hold personal property through a company since companies are taxed on all gains from property whereas individuals are exempt from tax on gains on many types of personal property.

<sup>159</sup> See Income Tax Act, *supra* note 2, § 17.

<sup>160</sup> Since general partnerships are conduit entities for income tax purposes, they are not themselves subject to the tax. The Czech State Bank is also exempt from the tax.

<sup>161</sup> The tax base of a limited partnership is then further reduced under section 23(5) by amounts due to the general partners. See Income Tax Act,

include all juridical entities (including limited partnerships) other than general commercial partnerships.

Corporate taxpayers with their headquarters in the Czech Republic are taxable on their worldwide income. Taxpayers who do not have their headquarters in the Republic are taxed only on Czech-source income, and that income is taxed at special rates under section 36.<sup>162</sup>

## 5.2. *Income Subject To Tax*<sup>163</sup>

The income tax applies to income from business activities and the trading or management of property, unless otherwise provided. In the case of an investment company which establishes mutual funds, the tax applies to the income of the investment company as well as the mutual funds, except that the income for purposes of the corporate tax excludes that portion of the income that is subject to a special rate under section 36.<sup>164</sup>

The Act states that property received by gift or inheritance is not subject to the corporate tax, but that income generated by the property is subject to the tax.<sup>165</sup>

If a company is not established for the purpose of conducting a business, the tax applies only to (1) income from activities carried out with a profit motive or from activities capable of generating a profit, (2) income from rent and from advertisements, (3) income subject to withholding tax, and (4) income from membership dues other than dues exempted under section 19.<sup>166</sup> This rule also applies to associations of companies, if such associations are themselves legal entities, to civic associations (including trade union organizations), political parties and movements, churches and religious associations recognized by the State, foundations, state funded

*supra* note 2, § 23(5).

<sup>162</sup> *See id.* § 36.

<sup>163</sup> *Id.* § 18.

<sup>164</sup> The reference to section 36 combined with the reference in section 23(4)(a) seems to mean that the distributions by the mutual fund are taxed at a special 25% rate under section 36(2)(a) and that the remainder of the income is included in the tax base. *Id.* §§ 36(2)(a), 23(4)(a).

<sup>165</sup> It would seem to be unusual for a legal entity to receive property by gift or inheritance.

<sup>166</sup> *See Income Tax Act, supra* note 2, § 19.

and subsidized organizations, state funds, health care funds, social funds, and the employment fund.<sup>167</sup> In the case of the National Property Fund and municipalities, the tax applies only to income from securities.

### 5.3. Tax Exemptions<sup>168</sup>

The statute provides the following exemptions:

(a) membership dues received by associations of legal entities<sup>169</sup> that pursue the joint interests of their members, civic associations, trade union organizations, and political parties and political movements;<sup>170</sup>

(b) income of companies not organized for business purposes from activities which are the purpose of the companies and which activities do not compete with another person, if the income is in proportion to the expenses incurred;<sup>171</sup>

(c) income from collections in churches, income from religious activities of churches and regular contributions made by members of churches and religious organizations recognized by the state;<sup>172</sup>

(d) income of cooperatives from rents and payments connected with the use of cooperative apartments and garages;<sup>173</sup>

(e) for the first calendar year of operation and the following five years, income from small hydroelectric plants

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<sup>167</sup> It is not clear whether organizations such as civic and religious associations are taxed on all of their income derived from activities with profit-making purposes, or only on their income from activities unrelated to the associations' nonprofit purposes.

<sup>168</sup> See Income Tax Act, *supra* note 2, § 19.

<sup>169</sup> Although the term "association of *legal entities*" seems to exclude associations of natural persons such as social or athletic clubs, neighborhood associations, community bands and orchestras or other cultural groups, the term "civic associations" apparently has a broad enough meaning to cover such groups of natural persons.

<sup>170</sup> Income Tax Act, *supra* note 2, § 19.

<sup>171</sup> *Id.* This seems to create a category of not-for-profit companies whose income is exempt so long as it does not compete with other (presumably taxable) persons and is not excessively profitable as compared with the costs incurred.

<sup>172</sup> *Id.*

(up to 1 MW output) and from environmentally friendly projects such as wind power stations, thermal pumps, solar equipment, equipment for the production of bio-gasses, equipment for the use of geothermal energy and equipment for the production of certain biodegradable materials;<sup>174</sup>

(f) income of state funds as set forth in separate legislation or decree;<sup>175</sup> and

(g) income from licensed<sup>176</sup> lotteries and similar games of chance, if at least 90% of the income is intended for the benefit of the public.<sup>177</sup>

#### 5.4. Tax Base<sup>178</sup>

In determining the tax base, a host of statutory rules, as discussed in the succeeding sections, apply.

A specific rule dealing with taxpayers that are undergoing liquidation or dissolution states that the tax base for those taxpayers is the amount by which the income from liquidating the taxpayer's assets exceeds the liquidation related costs.<sup>179</sup>

As is the case with individuals, the tax base is reduced by certain contributions. The list is the same as for individuals: the contributions must be given to municipalities or legal entities with headquarters in the Czech Republic to finance education and educational institutions, culture, fire-fighting, the support and protection of youth, social care, medical care, environmental, humanitarian and charitable purposes, religious purposes for churches and religious associations recognized by the state, for physical training and sports clubs and for protection of abandoned animals and endangered animal species. However, the threshold and maximum

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<sup>174</sup> *Id.* This exemption is available only to the first owner and is identical to the exemption afforded to natural persons under section 4. As with the section 4 exemption, it is waivable, which may be relevant under section 34(6)'s prevention of loss carryovers when an exemption applies.

<sup>175</sup> *Id.*

<sup>176</sup> Licensed under the Act on Lotteries and Other Games of Chance, č. 202/1990 Sb.

<sup>177</sup> Income Tax Act, *supra* note 2, § 19.

<sup>178</sup> *Id.* § 20.

<sup>179</sup> Since the company's income would generally otherwise be taxable, the effect of this rule is to make the liquidation expenses deductible. Special accounting rules apply in liquidation situations.



amounts are more stringent than the amounts for individuals. Contributions are not deductible by a legal entity if<sup>180</sup> the amount of the contribution is less than 2,000 crowns; further, no more than 2% of the tax base may be deducted for contributions.

As with individuals, the tax base is rounded down before calculating the tax. For legal entities, the rounding down is to the nearest 1,000 crowns.

### 5.5. Tax Rate<sup>181</sup>

Corporate income is taxed at a flat rate of 45%. There are no graduated rates for corporations.<sup>182</sup>

## 6. PROVISIONS APPLICABLE TO BOTH NATURAL AND LEGAL PERSONS

### 6.1. Income Source Rules<sup>183</sup>

Income from Czech sources includes:

(a) income from activities carried out through a permanent establishment, as defined below;<sup>184</sup>

(b) income from dependent activities performed in Czech territory or aboard Czech flag ships or Czech aircraft;<sup>185</sup>

(c) income from commercial, technical or other advisory services, agency services and similar activities provided in Czech territory;<sup>186</sup>

(d) income from payments made by legal entities with their headquarters in, or by natural persons resident in, Czech territory including, but not limited to:

1. payments received for granting the use of industrial property rights, designs, models, and drawings; and income from providing production, technical and other

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<sup>180</sup> As with the contribution deduction for natural persons the word "if" should logically be replaced with "to the extent that." See *supra* note 155.

<sup>181</sup> Income Tax Act, *supra* note 2, § 21.

<sup>182</sup> *Id.*

<sup>183</sup> *Id.* § 22.

<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

- know-how useful in business;<sup>187</sup>
2. payments for the use of copyrights or similar rights;<sup>188</sup>
  3. income from the independent activity of lecturers, artists, architects, athletes, performing artists, and their assistants carried out or remunerated<sup>189</sup> in Czech territory;<sup>190</sup>
  4. shares in profits and settlement amounts, shares in the liquidation surplus of general commercial partnerships and cooperatives, and other income from capital assets;<sup>191</sup>
  5. after tax profits paid to a silent partner;<sup>192</sup>
  6. interest and other income from loans and credits, deposits, and securities;<sup>193</sup>
  7. income from renting property located in Czech territory;<sup>194</sup>
  8. emoluments paid to members of statutory bodies and other bodies of legal entities;<sup>195</sup> and
  9. income of partners in general commercial partnerships

<sup>187</sup> *Id.* This source rule seems to provide that royalty types of payments made by a Czech resident is Czech source income even if the property right for which the royalty is paid is not used in Czech territory. Under Paragraph 6(a) of Article 12 of the U.S./C.R. Treaty, royalties are generally sourced where the payer is located. See U.S./C.R. Treaty, *supra* note 16, art. 12(6)(a). The types of royalty described in the text at this footnote are taxed at 10% under Paragraph 3(b) of Article 12 of the treaty. *Id.* art. 12(3)(b).

<sup>188</sup> Income Tax Act, *supra* note 2, § 22. Again, there seems to be no requirement that the property right be exploited in the Czech Republic. Under Paragraph 3(a) of Article 12 of the U.S./C.R. Treaty, these types of royalty are exempt from Czech tax. U.S./C.R. Treaty, *supra* note 16, art. 12(3)(a).

<sup>189</sup> The reference to "remunerated" means that if the services are performed outside of Czech territory but paid for from within Czech territory, the payments thereby become Czech source income. This is consistent with the source rule for royalty types of payments.

<sup>190</sup> Income Tax Act, *supra* note 2, § 22.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* Does this mean that the profits paid to a silent partner are taxed twice (one to the payor and then again to the silent partner)? Why is "after tax" relevant in a source rule?

<sup>193</sup> *Id.*

<sup>194</sup> *Id.*

and other partnerships.<sup>196</sup>

A “permanent establishment” is a facility within Czech territory through which nonresident individuals or foreign companies conduct their activities. A permanent establishment includes, but is not limited to, construction sites, workshops, mines, and sales offices. Building sites and construction and assembly work, including repair work, are considered permanent establishments only if their duration (regardless of the tax period) exceeds six months.<sup>197</sup>

The statute makes it clear that “income” for purposes of the source rules includes nonmonetary consideration.<sup>198</sup>

## 6.2. Tax Base<sup>199</sup>

The tax base is the difference between income (other than tax-free income as provided in sections 4 and 19) and the expenses (costs) incurred to achieve, ensure and sustain the income, taking into consideration substantive and time relationships between the income and expenses in the relevant tax period as adjusted in accordance with the following three paragraphs:

1. The tax base of taxpayers using double entry bookkeeping is the economic result (profit or loss). The tax base of taxpayers using single entry bookkeeping is the difference between income and expenses.<sup>200</sup>
2. The profit or loss, or the difference between income and expenses under the preceding paragraph, is adjusted for amounts which, under the Act, cannot be deducted or which cannot be deducted to the full

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<sup>196</sup> *Id.*

<sup>197</sup> The statute provides that the duration of a permanent establishment is measured in calendar days, but it is discontinued if the activity is interrupted for more than 12 consecutive calendar months. It appears that the only place in the permanent establishment definition where duration is relevant is the six month exemption provided for building, assembly and repair work. However, if this is the only place where duration is relevant, it would not have been necessary to provide for a 12 month hiatus to terminate the duration of the permanent establishment.

<sup>198</sup> See Income Tax Act, *supra* note 2, § 22.

<sup>199</sup> *Id.* § 23.

extent incurred,<sup>201</sup> and by all amounts which "unjustly" reduced income. If the extent of certain expenses is restricted or limited by the Act or by separate legislation or decree, then for purposes of calculating the tax base, only the maximum permissible amount of the cost, properly substantiated, can be deducted.<sup>202</sup>

3. The tax base does not include:

- (a) income subject to a special rate of tax under section 36, with the exception of investment companies establishing mutual funds;<sup>203</sup>
- (b) income from the premium on the issuance of securities;<sup>204</sup>
- (c) income from the purchase by an entity of its own shares for less than their nominal value;<sup>205</sup> and
- (d) amounts which have already been taxed under the Act to the same taxpayer.<sup>206</sup>

The tax base of a limited partnership is reduced by the amounts due to the general partners.

The Act reiterates the principle that income includes nonmonetary consideration valued according to those prices customary at the time and place of delivery or consumption, depending on the type, quality and condition of the goods or services in question, except for the consumption by the taxpayer of its own products and services (which, presumably, is not income).

If a contract price differs from the usual market price and this difference cannot be satisfactorily documented,<sup>207</sup> the usual market price is used for tax purposes. In the case of transactions between related taxpayers, usual market prices will always be used irrespective of the contract price.<sup>208</sup> For

<sup>201</sup> That is, they are inappropriate in amount.

<sup>202</sup> Income Tax Act, *supra* note 2, § 23.

<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> The issue would not seem to be one of documentation but rather of commercial reasonableness or other justification.

<sup>208</sup> The rule, by its terms, applies to "price." This seems to fall short of

this purpose, two taxpayers are related if the same persons participate, directly or indirectly, in the management, control or ownership of the parties. If, in a sale of real estate, the price is less than two thirds of the value as determined by an officially certified expert or special ruling, the latter value will prevail.<sup>209</sup>

In the case of an entity being liquidated or dissolved, the tax base for the period preceding the date when the winding up began is adjusted to take account of the balance of reserves created as well as deferred revenues and costs.<sup>210</sup> In the case of a taxpayer using single entry bookkeeping, the tax base is adjusted by the amount of unused inventories and by the amount of payables and receivables.

The tax base is required to be calculated according to accounts kept pursuant to separate accounting rules unless some other legislation, decree, or the Act otherwise provides, or unless tax liability is reduced another way.

If a foreign taxpayer has a permanent establishment in the Czech Republic, the tax base may not be lower than the tax base from a similar activity by a Czech resident taxpayer. In order to make that comparison, the ratio of profit to expense (or gross income) of comparable taxpayers (or activities) can be used, as can comparable margins, commissions, and other comparable data.

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the general provision found in many tax laws subjecting related taxpayers to an arms-length standard for all transactions.

<sup>209</sup> The Act seems to say literally that the rule of paragraph 7 of section 23 will always apply in the case of such a sale of real estate. The result of the language is not clear. Does it mean that the value as set by the expert or ruling prevails or does it mean that the customary market price prevails? This may not be a meaningful distinction unless there is a mechanism for resolution of tax disputes that would enable the taxpayer to prove the customary market price. As a practical matter, many taxpayers will want to obtain an expert's appraisal to avoid controversy with the fiscal authorities. If the taxpayer does not have such an appraisal, the government can obtain one.

<sup>210</sup> The effect of this rule is to accelerate these items into the final operating period rather than take account of them during the liquidation period. Presumably the amount of the reserves and deferred revenues and costs are already known when the taxes for the pre-winding up period are

### 6.3. Expenses (Costs) Incurred To Achieve, Secure, And Sustain Income<sup>211</sup>

In order to calculate tax base, substantiated expenses incurred to achieve, secure, and sustain income are deductible to the extent stipulated by the Act or separate legislation.<sup>212</sup>

"Expenses (costs)" also include:

- (a) depreciation of tangible and intangible assets;<sup>213</sup>
- (b) the "residual value"<sup>214</sup> of tangible and intangible assets, but only up to the extent of proceeds from their disposition, or up to the amount of the consideration included in the tax base;<sup>215</sup>
- (c) contributions paid to legal entities if required by law;<sup>216</sup>
- (d) insurance premiums paid by the taxpayer, if the insurance is related to taxable income;<sup>217</sup>
- (e) insurance premiums paid by an employer pursuant to separate legislation<sup>218</sup> and expenses related to social benefits provided instead of mandatory insurance benefits;<sup>219</sup>
- (f) expenses of operating environmental protection equipment pursuant to separate legislation or decree;<sup>220</sup>

<sup>211</sup> Income Tax Act, *supra* note 2, § 24.

<sup>212</sup> See, e.g., Act on Reimbursement of Travel Expenses, č. 119/1992 Sb.

<sup>213</sup> Depreciation is provided for under sections 26 to 33. Income Tax Act, *supra* note 2, §§ 26-33.

<sup>214</sup> This term is defined in section 29(2). It encompasses the concept of adjusted tax basis. See *id.* § 29(2).

<sup>215</sup> *Id.* § 24. The effect of this rule is that the taxpayer is entitled to recover the basis of property (adjusted for depreciation) before amounts received in respect of the property become taxable.

In addition, there is a special rule dealing with livestock and fruit and nut bearing trees and shrubs. The rule allows the recovery of the cost of the livestock when it is removed from the herd. The operation of the rule is less clear as applied to fruits and nuts. Does it allow the orchard owner to recover the cost of the trees and shrubs against the income from sale of the fruit, so that the revenue from the sale of the fruit does not become taxable until the revenue exceeds the cost of the trees or does it allow the recovery of the cost only when the trees and shrubs themselves are disposed?

<sup>216</sup> *Id.*

<sup>217</sup> *Id.*

<sup>218</sup> See, e.g., Employment Act, č. 1/1991 Sb.

<sup>219</sup> Income Tax Act, *supra* note 2, § 24.

<sup>220</sup> See, e.g., Act on Waste, č. 238/1991 Sb; Air Protection Act, č. 309/1991

(g) rent, including rent paid under a lease that provides a purchase option;<sup>221</sup>

(h) real estate tax, road tax and, except as provided in section 25, other taxes and fees related to activities that generate taxable income;<sup>222</sup>

(i) reserves the creation and amount of which is required by separate law;<sup>223</sup>

(j) costs related to providing proper working and social conditions and health care in connection with:

1. safety and health care protection and sanitary facilities at the workplace;<sup>224</sup>
2. operation of medical and health care facilities for employees as required by legislation or decree;<sup>225</sup>
3. operation of vocational schools and other education facilities unless paid for by the appropriate state administrative body, or amounts paid to other entities for the teaching, training or retraining of the taxpayer's employees; and
4. certain costs of operating a company canteen;<sup>226</sup>

(k) cost of business trips, not exceeding the maximum amounts set forth in separate legislation,<sup>227</sup> consisting of:

1. substantiated costs of accommodations, public transportation, and necessary out of pocket expenses related to the business trip;<sup>228</sup>
2. if the transportation is not in the taxpayer's own vehicle, a deduction at a "basic rate" (or twice the basic rate if the vehicle is a truck or a bus) is allowed in addition to the cost of the fuel consumed; if the vehicle is the taxpayer's, an allowance, based on fuel con-

<sup>221</sup> However, see the discussion below regarding section 24's limitation on the deductibility of rent under leases with purchase options.

<sup>222</sup> Income Tax Act, *supra* note 2, § 24.

<sup>223</sup> *Id.*

<sup>224</sup> *Id.*

<sup>225</sup> See, e.g., Decree of the Czech Ministry of Health, č. 242/1991 Sb; Act on Public Health Care, č. 86/1992 Sb.

<sup>226</sup> The deductible costs of operating a canteen do not include the cost of foodstuffs. If the canteen services are provided by an outside contractor, only 55% of the price of the meals and snacks provided is deductible.

<sup>227</sup> See, e.g., Act on Reimbursement of Travel Expenses, č. 119/1992 Sb.

- sumed, applies;<sup>229</sup>
3. travel and meal expenses for foreign business trips;<sup>230</sup>
  4. meal expenses for domestic business trips of "employees" and other functionaries described in section 6;<sup>231</sup>
    - (l) damages caused by natural disasters;<sup>232</sup>
    - (m) expenses for fire prevention;<sup>233</sup>
    - (n) expenses connected with the maintenance of production capacity to secure the national defense;<sup>234</sup>
    - (o) expenses the payment of which is required by separate legislation or decree;<sup>235</sup>
    - (p) the residual price of property taken by eminent domain reduced by any compensation paid;<sup>236</sup>
    - (q) the cost of securities sold;<sup>237</sup>
    - (r) for taxpayers using double entry bookkeeping, the amount of accounts receivable sold, up to the amount received from sale;<sup>238</sup> and

<sup>229</sup> *Id.* This "basic rate" is set forth in separate legislation. For transportation in the taxpayer's vehicle (whether owned or leased by the taxpayer) the deduction is, at the taxpayer's election, either (A) 120% of the fuel cost in the case of passenger cars or 125% (130% if operated with a trailer) in the case of trucks and busses, or (B) the fuel cost plus (i) 15% for milage driven during merchandise deliveries, when rendering service with frequent stops or in taxi or driving school use; plus (ii) 5% for milage driven in a city with a population over 1000,000 at the last census; plus (iii) 5% for milage driven during November through February. The taxpayer must use either method A or method B for all vehicles owned by the taxpayer during the year and the method may not be changed during the year.

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

<sup>232</sup> *Id.* The reference to "natural" disasters would seem to exclude disasters of human origin whether intentional, negligent or totally accidental.

<sup>233</sup> *Id.*

<sup>234</sup> See Edict on Measure Concerning Economic Mobilization, §. 284/1992 Sb. It would seem that all expenses to achieve, secure and sustain business production capacity would be deductible. The purpose of this national security provision in the Act is not clear; it may be that its purpose is to encourage the maintenance of production capacity that no longer has a business/profit-making purpose.

<sup>235</sup> Income Tax Act, *supra* note 2, § 24.

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Id.* This suggests the simple rule that if the income from a receivable



(s) in the case of the sale of land or other nondepreciable property, the cost of the property.<sup>239</sup>

In the case of taxpayers earning income only from business or "other activities" specified in the Act, only those expenses incurred to achieve, secure and sustain such taxable income are allowed as expenses.

Rent paid under a lease that includes a purchase option is deductible only if (i) the term of the lease is longer than 20% of the depreciation period for the property as set forth in section 30 of the Act, but not less than three years (eight years in the case of real property), and (ii) the purchase price is not more than the residual value that the property would support<sup>240</sup> if it were depreciated using the straight-line method in accordance with the Act. The Act goes on to say that if leased property is sold to the lessee at the termination of the lease under circumstances other than those just described, the rent can be deducted only if the purchase price is not lower than the post-depreciation, residual value of the property.<sup>241</sup>

An item conspicuously absent from the list of deductible items is interest. Nevertheless, if there is adequate substantiation, interest paid to achieve, secure or sustain income will be deductible, unless it falls within the list of nondeductible items in section 25.<sup>242</sup>

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has already been taken into account, no further income should result if the receivable is sold.

<sup>239</sup> *Id.*

<sup>240</sup> Presumably at the time at which the option (first?) becomes exercisable. Perhaps the Act's drafters had only a fixed option price in mind.

<sup>241</sup> This rule seems to disallow the deduction of *all* rent if the purchase price is too low rather than disallowing only that portion of the rent that is equal to the amount by which the purchase price is too low.

Also, it is interesting to consider how this rules works procedurally. Presumably the way that it operates is that the lessee will deduct the rent on a current basis, but if the lessee then buys the property for less than its residual value, the rent deductions are disallowed retroactively. If the lease is of long duration, the disallowance of the rent deduction may be barred by a statute of limitations. It is unlikely that all rent deductions are held in suspense until it is known whether or not the lessee purchased the property.

#### 6.4. Items Not Deductible<sup>243</sup>

The Act specifies 22 items that are not deductible. In general, they are (i) items that must be capitalized, including "technical appreciation" or improvements to property,<sup>244</sup> (ii) fines and penalties,<sup>245</sup> (iii) expenses to generate tax-free income or other income not included in the tax base, (iv) personal expenses and taxes,<sup>246</sup> (v) amounts set aside as reserves,<sup>247</sup> (vi) dividends and other profit share distributions paid by a company as well as excessive interest paid to a related lender that would otherwise strip the company of its tax base,<sup>248</sup> and (vii) a few miscellaneous items

<sup>243</sup> *Id.*

<sup>244</sup> These are (i) cost of acquisition of tangible and intangible property as defined in section 26; (ii) the costs of a company increasing its capital, including the repayment of loans; (iii) expenses to purchase securities (except as specifically provided in section 24); (iv) contributions to the basic capital and purchase of shares in the basic capital of a company or a cooperative, and the cost of "technical appreciation" or improvement of property (addition to, or modification, reconstruction or modernization of, the property). The Act defines "reconstruction" as alteration of a tangible asset resulting in a change in its purpose (use?) or its technical characteristics. The Act defines "modernization" as improving the equipment or utility of a tangible asset.

The cross reference to the section 26 definition of tangible and intangible property suggests that property that does not meet the definition (because, for example, it has a cost below 10,000 crowns or has a useful life of not more than one year) can be immediately expensed.

<sup>245</sup> These are (i) penalties and fines (other than contractual penalties) and surcharges on insurance premiums paid to the social insurance, health insurance and employment funds; and (ii) surcharges to the basic charges for polluting the air and discharging sewage.

<sup>246</sup> These are (i) taxes paid on another taxpayer's behalf; (ii) expenses for the taxpayer's personal needs; and (iii) inheritance tax, gift tax, and real estate transfer tax. The Act also specifies that the personal income tax and the corporate tax are not deductible, establishing the circularity avoiding proposition that a tax is not deductible in determining that very tax.

<sup>247</sup> Amounts set aside as reserves or other funds can be deductible if required by separate legislation or decree.

<sup>248</sup> Interest paid to entities participating directly or indirectly in the management, control or capital of the paying company is not deductible to the extent that the total indebtedness for loans and credits so provided during the tax year exceeds four times (six times in the case of loans or credits to banks and insurance companies) the paying company's registered capital. If the lenders are unrelated to the borrower, the debt limitation is ten times the registered capital. Participation in management or capital means the ownership of a share in the capital or voting rights exceeding

peculiar to the Act. These peculiar items are (i) Emoluments of members of the statutory body and other bodies of legal entities; (ii) expenses above the limits set forth in the Act or by separate legislation or decree;<sup>249</sup> (iii) the residual value of property taken out of use except as allowed in section 24,<sup>250</sup> and (iv) entertainment expenses.

## 7. DEPRECIATION

The Act devotes eight sections to the subject of depreciation, far more than is devoted to any other subject.

### 7.1. Operating Rules<sup>251</sup>

Under the Act, tangible and certain intangible property (each as defined in section 26 for purposes of the depreciation rules) is subject to depreciation.<sup>252</sup> The taxpayer may elect either straight-line or accelerated depreciation subject to the rules described below.

For purposes of the Act, tangible assets mean personalty whose "input price" is more than 10,000 crowns and whose economic life exceeds one year;<sup>253</sup> buildings; cultivated areas of perennial plants yielding a harvest for at least three years; "basic" livestock herds; draught animals, stud and race horses; and other assets. "Other assets" consist of technical appreciation,<sup>254</sup> expenses incurred in opening new quarries, and sand and clay pits,<sup>255</sup> and "technical recultivation,"<sup>256</sup>

<sup>249</sup> Expenses over statutory allowances include the following items specified in section 25: (i) expenses exceeding income from facilities provided for satisfying the needs of employees or other persons except as provided in section 24(2)(j) and (ii) except as allowed in section 24, losses and damages exceeding compensation received. Income Tax Act, *supra* note 2, § 25.

<sup>250</sup> Thus the remaining basis of property that is no longer used cannot simply be written off. However, the property can continue to be depreciated.

<sup>251</sup> Income Tax Act, *supra* note 2, § 26.

<sup>252</sup> *Id.*

<sup>253</sup> It is logical to assume that personal property with a cost of 10,000 crowns or less, or with a useful life of one year or less can be immediately expensed. However, the Act does not state this.

<sup>254</sup> As defined *supra* note 191.

<sup>255</sup> The reference to "opening" indicates that only the costs of preparing the site are recoverable by depreciation. Section 27(g) makes it clear that the costs of acquiring the depositary mineral deposits are not deductible.

unless they increase the input price and residual value of the tangible asset in question.<sup>257</sup> Intangible assets mean industrial property rights, designs, software, and technical know-how and other economically usable know-how whose input price is more than 20,000 crowns, has an operational and technical life-span of more than one year, and is either purchased by the taxpayer or created by the taxpayer at the taxpayer's cost.

Depreciation deductions for a year are determined by reference to the depreciable property owned by the taxpayer on December 31st of that year. If the taxpayer owned the property on January 1st, but disposed of it during the year, the taxpayer can take one-half of a year's depreciation.

### 7.2. Nondepreciable Property<sup>258</sup>

The following items are specified in the Act as being nondepreciable: (i) perennial plants that have not yet reached producing age,<sup>259</sup> "hydroamelioration" (irrigation) projects, within two years of the time of their completion; water flow, flood, and woodland improvement projects; works of art that are not part of some other property; cultural monuments that cannot generally be valued under applicable regulation;

See Income Tax Act, *supra* note 2, § 27(g). In addition, the reference only to quarries and sand and clay pits leaves out some important mineral related expenditures such as mine and well development costs.

<sup>256</sup> "Technical recultivation" probably refers to land reclamation after, or in connection with, mining or quarrying.

<sup>257</sup> The exclusion from the definition of tangible property of "other assets" that increase the value of tangibles is anomalous, unless it increases the residual value of the property by at least as much as the cost of the other assets. If the increase in the value of the tangible asset is less than the cost of the other assets, there will be an economic loss of investment that is not recoverable through depreciation. It would make more sense to provide that such an expenditure becomes part of the "other assets" to the extent that it increases the residual value of property and that the remainder, since it is not "property" of any kind within the meaning of section 26, is therefore deductible.

<sup>258</sup> Income Tax Act, *supra* note 2, § 27.

<sup>259</sup> It is rational to postpone the depreciation of plants until they begin to bear fruit, if it is important to match deductions directly with the income to which they relate. On the other hand, arguably, the owner of an orchard should be able to recover the capital investment in the trees beginning from the day on which the investment in the trees is made.

surface and underground water, forests, mineral deposits,<sup>260</sup> caverns, surveying signs, markers, and printed material for state maps; and tangible property seized without compensation under special legislation,<sup>261</sup> and (ii) intangible assets contributed to a partnership or cooperative by a partner or a member, respectively.

*7.3. The Taxpayer Who Can Take The Depreciation Deduction; Depreciation Of Property Only Partly Used To Generate Income*<sup>262</sup>

Generally, owners of depreciable property reap the benefit of depreciation deductions. However, in the case of a lease of a combination of both realty and personalty used by the lessee to generate income during the entire lease, the lease may provide that the depreciation be taken by the lessee. The cost of "technical appreciation" of tangible property paid for by the lessee can be depreciated by the lessee if the lease so provides and if the owner does not claim an addition to the input price of the property.<sup>263</sup> Technical appreciation is depreciated by the lessee as if the technical appreciation was of the same character as the leased property.

Co-owners (and perhaps co-tenants) of depreciable property can either agree that only one of the co-owners take all of the depreciation deductions on the property, or that the depreciation deductions be allocated in proportion to their ownership interests.<sup>264</sup>

If property is only partially used to generate taxable income, only a proportionate part of the depreciation is deductible.

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<sup>260</sup> Since the Act contains no general rule allowing the depletion of mineral reserves that are exhausted as they are exploited, the removal of mineral deposits from the list of depreciable assets means that the costs of acquiring mineral deposits are totally nonrecoverable.

<sup>261</sup> See, e.g., Electrification Act, č. 79/1957 Sb; Act on Gas, č. 67/1960 Sb; Act on Water, č. 138/1973 Sb.

<sup>262</sup> Income Tax Act, *supra* note 2, § 28.

<sup>263</sup> Query how the owner can claim an addition to the input price for something for which the owner has incurred no cost, unless the owner has included the cost in income.

#### 7.4. Definitions Of Certain Terms<sup>265</sup>

"Input price" is (i) the cost of property acquired for consideration,<sup>266</sup> (ii) the taxpayer's own cost if the property is acquired or manufactured internally, or (iii) the replacement or reproduction cost determined according to applicable separate legislation or decree, or as determined by a court appointed expert.<sup>267</sup> Any technical appreciation made during the first depreciation-year is added to the input price.

"Residual value" is the input price of the property less depreciation deducted.

Technical appreciation not deducted by a lessee is added to the input price and the residual value of the tangible property at the beginning of the next tax period.

#### 7.5. General Depreciation Rules<sup>268</sup>

In the first year of depreciation, the taxpayer must classify each of the items of depreciable property into one of five depreciable lives according to categories described in the Annex to the Act.<sup>269</sup> The depreciable lives are as short as 4 years for property such as small power tools, passenger and light commercial vehicles, and pigs and poultry, and as long as 50 years for buildings.<sup>270</sup> The taxpayer can elect to use

<sup>265</sup> *Id.* § 29.

<sup>266</sup> There is an exception for property acquired under the 1990 Act for Transfer of Certain State-Owned Assets to Other Legal or Natural Persons, known as the Small Scale Privatization Act.

<sup>267</sup> Does this mean any case in which a court chooses to appoint a valuation expert?

<sup>268</sup> Income Tax Act, *supra* note 2, § 30.

<sup>269</sup> The Annex assigns most property to one of five depreciation categories. Some examples are:

1. small hand tools; machinery for cultivation of plants; animals other than stud and racing horses; data processing and reprographic equipment; computer programs;
2. most machinery and equipment other than heavy machinery; trucks, wagons and tractors; aviation equipment; most intangibles other than computer programs and patents;
3. patents; heavy machinery; perennial crops; stud and racing horses;
4. certain specialized structures; buildings and halls made from wood and light materials; and
5. remaining structures, buildings and halls.

*Id.* annex.

<sup>270</sup> The categories are as follows:  
<https://scholarship.law.upenn.edu/jiv/vol15/iss1/1>

either the straight-line method or an accelerated method for a particular item of property; but, the method cannot be changed thereafter during the depreciation period of that item of property in the hands of the taxpayer or any "legal successor."<sup>271</sup> Further, total depreciation with respect to a piece of property cannot exceed its input price.

Ninety percent of the cost of personal property leased with a purchase option may be depreciated using the straight-line method over the term of the lease, if the lease term spans at least 40% of the property's depreciable life. If the lease term exceeds 40% of the item's depreciable life, then, for each percentage point over 40%, a further 1% of the input price can be depreciated; provided such depreciation does not exceed 100%.

7.6. *Straight-Line Depreciation*<sup>272</sup>

The Act contains a table for calculating straight-line depreciation.<sup>273</sup> The table generally allows a little less than one-half of a full year's depreciation for the year in which the

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<u>Depreciation</u> <u>Category</u>	<u>Period of</u> <u>Depreciation</u>
1	4 years
2	8 years
3	15 years
4	30 years
5	50 years

*Id.*

Molds, models and templates may also be depreciated based on the number of times they are used as compared with the prescribed number of castings or pressings for which they are useable.

<sup>271</sup> The term "legal successor" is not defined in the Act.

<sup>272</sup> Income Tax Act, *supra* note 2, § 31.

<sup>273</sup> The full table is set forth below:

<u>Depreciation</u> <u>Category</u>	<u>First</u> <u>Year</u>	<u>Subsequent</u> <u>Years</u>	<u>For Increased</u> <u>Input Price</u>
1	14.2%	28.6%	25.0%
2	6.2%	13.4%	12.5%
3	3.4%	6.9%	6.7%
4	1.4%	3.4%	3.4%
5	1.0%	2.0%	2.0%

It would appear that for category 5 (50-year property) the allowable depreciation is only 99% of the input price since 49 years at 2% plus one

depreciation begins<sup>274</sup> and then slightly more than double that amount for the property's remaining depreciable life. For example, in the case of property to be depreciated over eight years, the first year's depreciation is 6.2% and then each of the remaining seven years' depreciation is 13.4%. A special table is provided for increased input price of an item of tangible property.<sup>275</sup> Under that table, the annual depreciation percentage is equal to 100% divided by the property's depreciable life.<sup>276</sup>

### 7.7. Accelerated Depreciation<sup>277</sup>

The Act provides a method of accelerated depreciation that is equivalent to double-declining balance for the first year and then somewhat similar to double-declining balance for the subsequent years. There is no switch to straight-line at any point along the way. A special table is provided for increases in residual value of tangible property resulting from "technical appreciation" or improvement.<sup>278</sup>

<sup>274</sup> Except as otherwise provided in the Act (as is the case, for example for fruit trees that have not yet begun to bear fruit), depreciation begins in the tax year during which the taxpayer acquired the property, if it is still held on December 31st of that year. There seems to be no delay, for example, if the property is not yet placed in service.

The rule that gives approximately one-half of a full year's depreciation for the first year is probably a rule of convenience that gives all taxpayers a half year of depreciation regardless of when during the year the property is acquired.

<sup>275</sup> Note the fourth column of the table *supra* note 273.

<sup>276</sup> There seems to be no half-year rule for increased input price. Therefore, if a taxpayer increases the input price on the last day of the year, he can still claim a full year's depreciation.

<sup>277</sup> Income Tax Act, *supra* note 2, § 32.

<sup>278</sup> The table is as follows:

Depreciation Category	Coefficient For Accelerated Depreciation		
	First Year	Subsequent Years	For Increased Residual Value
1	4	5	4
2	8	9	8
3	15	16	15
4	30	31	30
5	50	51	50

*Id.* § 32.

For the first year, the depreciation is equal to the input price divided by the first year coefficient. For subsequent periods, the depreciation is twice the residual value divided by a number equal to the subsequent years'



## 8. MISCELLANEOUS PROVISIONS

*8.1. Carryover Of Losses And Special Deduction For Tangible Property*<sup>279</sup>

A loss sustained in a tax period may be deducted in subsequent tax periods, but not later than the fifth subsequent period. This rule does not apply to unit trusts and investment funds. In determining the amount of the loss, the general rules for determining the tax base apply except that the deductions otherwise allowable under section 20(4) for contributions for civic and charitable purposes are not allowed. There is a provision that may state that if carried over losses are deducted in a subsequent year, then no tax holidays or exemptions will be granted. However, the language of the Act is so unclear that another translator remarks that the deduction of losses does not prevent the applicability of tax exemptions.

A deduction of 10% of the input price of certain tangible property with longer depreciable lives is allowed in the first year of ownership if the property is held for at least three years (the Act does not specify how it is known in the first year how long the property will be held). The deduction does not apply to (i) motorcycles, passenger cars (other than cars used in operating a licensed car service), or aircraft, (ii) property which is outside of the Czech Republic for more than 183 days during the calendar year, and (iii) rented property.

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coefficient *minus* the number of years for which the property has already been depreciated.

If the residual value of tangible property is increased as the result of "technical appreciation," the depreciation for the first year (the year in which the residual value is increased) is twice the residual value divided by the coefficient in the last column above. For subsequent periods, the depreciation is twice the residual value divided by a number equal to the number in the second column (some translations use the last column) minus the number of years for which the increased residual value has already been depreciated.

### 8.2. Tax Relief For Employers Of Disabled Employees<sup>280</sup>

Employers are entitled to a credit of 7,500 crowns for each disabled employee and 22,500 crowns for each severely disabled employee.<sup>281</sup> Companies that employ at least twenty employees, of whom disabled employees make up at more than 60% of the average number of employees, have the corporate tax rate reduced by one-half.

### 8.3. Special Tax Rates<sup>282</sup>

There is a special tax rate that applies to the Czech-source income of nonresident alien individuals and nonresident companies that do not have a permanent establishment in the Republic. That rate is 25% of the *gross* income from enumerated types of income. Generally, it is income from independent services, royalties and other income from intellectual property (other than the income of authors for material submitted to newspapers, magazines, radio and television), and interest, other than interest taxed at a 15% rate, as described below.<sup>283</sup> The 25% rate also applies to rent,<sup>284</sup> unless it is rent under a lease with a purchase

<sup>280</sup> *Id.* § 35.

<sup>281</sup> The terms "disabled" and "severely disabled" are defined in the Employment Act. Č. 1/1991 Sb, § 20. The calculation of the tax credit is based on the average number of disabled and severely disabled employees respectively for the tax period.

<sup>282</sup> Income Tax Act, *supra* note 2, § 36.

<sup>283</sup> The specifically enumerated income is income from commercial, technical or other advisory services, agency services and similar activities provided in Czech territory; and income from payments made by legal entities with their headquarters or by natural persons resident in Czech territory including: (i) payments received for providing and for the use of industrial property rights, for the use of designs, models and drawings and income from providing production, technical and other know-how useful in business, (ii) payments for the use of copyrights or similar rights, (iii) income from the independent activity of lecturers, artists, architects, athletes, performing artists, and their assistants carried out or remunerated in Czech territory, and (iv) interest and other income from loans and credits, deposits and securities.

<sup>284</sup> The Act does not provide a foreign lessor with the opportunity to be taxed at regular rates on only the net income. Obviously 25% of the gross income can be far higher than 45% (or 47%) of what the (net) tax base would otherwise be. Moreover, in many instances, the tax will exceed the profit, thereby making the tax confiscatory. Note, however, that, for example, Paragraph 5 of Article 6 of the U.S./C.R. Treaty allows a U.S. resident

option. This latter rental income is taxable only at a rate of 1%.<sup>285</sup>

A 25% rate applies to Czech-source income of resident individuals and companies consisting of dividends, interest, income from securities (other than income items subject to the special 15% tax as described below), participations (distributions) in limited liability companies and limited partnerships, shares in profits and similar distributions from cooperatives, shares in profits of silent partners, participations in business activities, settlement shares upon termination of a partner's interest in a commercial partnership or the termination of membership in a cooperative, and shares in the liquidation surplus upon the liquidation of a commercial partnership or cooperative. In the case of a company, the tax applies only to the gain resulting from the liquidation or termination of an interest in a cooperative or a company.

A special 20% rate applies to (i) income from prizes won in public competitions and sporting competitions from Czech sources; (ii) emoluments from Czech sources paid to members of a statutory body and other bodies of legal entities;<sup>286</sup> and (iii) income from deposits made by employees with their employers.

A special 15% rate applies to interest, "winnings" and other yields from passbook deposits, certificates of deposit, and similar deposits and benefits from endowment insurance policies and pension insurance policies (other than the social insurance fund) received by individual taxpayers.<sup>287</sup>

A special 10% rate applies to small amounts of occasional income and to the income of authors derived from newspapers,

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taxpayer to compute its income from Czech real property on a net basis in determining its Czech income tax. See U.S./C.R. Treaty, *supra* note 16, art. 6(5).

<sup>285</sup> The special 1% rate for a lessor of property under a purchase option does violence to the fisc unless there is a mechanism for bringing the rent back into income as part of the consideration paid upon exercise of the option.

<sup>286</sup> The special low rate of tax may be justified because the recipient is not entitled to take deductions for the cost of generating the remuneration.

<sup>287</sup> A special tax base applies for income from certain insurance policies that enables the taxpayer to recover the cost of the policy over its life. See

magazines, radio, and television.<sup>288</sup>

#### 8.4. *Effect Of Treaties*<sup>289</sup>

The Act specifically states that the provisions of the Act are overridden by any international treaty by which the Czech Republic is bound.

#### 8.5. *Foreign Currency Exchange Rates*<sup>290</sup>

The Act specifies that the foreign exchange rates set by the State Bank apply for tax purposes. In the case of taxpayers under an obligation to offer, the "buy" or "sell" rate at the time of clearance is used.<sup>291</sup> For all other taxpayers<sup>292</sup> the rate that is used is the "average" exchange rate announced by the State Bank on the last day of the calendar month preceding the transaction.

#### 8.6. *Powers Of The Ministry Of Finance*<sup>293</sup>

The Ministry of Finance is given the power to take measures (i) relating to foreign countries to insure reciprocity or to take retaliatory measures to achieve mutuality; and (ii) granting relief in situations involving foreign taxpayers, Czech taxpayers sent abroad, or Czech residents living abroad for at least ten years.

The Ministry may reduce the tax rate down to half of the

<sup>288</sup> This income is Czech source wages from employment (as defined at section 4.5. of this Article above) for a period not exceeding five calendar days per calendar month and not exceeding 3,000 crowns (approximately \$100) per calendar month, which constitutes a separate tax base. The tax base is reduced under section 6(12)(a) by certain insurance costs that must be paid by the employee.

<sup>289</sup> Income Tax Act, *supra* note 2, § 37.

<sup>290</sup> *Id.* § 38.

<sup>291</sup> Presumably this means that for transaction in which the taxpayer is obligated to buy, the "buy" rate is used and when the taxpayer is obligated to sell, the "sell" rate is used.

In the Czech Republic people are not permitted to hold foreign currency and thus are under an obligation to offer to sell it to a bank. Only banks are obligated to offer to buy foreign currency.

<sup>292</sup> It would be logical that this rule would also apply to taxpayers under an obligation to offer to buy or sell in transactions that do not involve this obligation. The Act does not say this, however.

<sup>293</sup> Income Tax Act, *supra* note 2, § 39.

usual rate for individual taxpayers who employ more than twenty workers and whose handicapped worker rate exceeds 60% of the average.<sup>294</sup>

The Ministry is also given the power to issue generally binding legal regulations in respect of the Act including the transition from single- to double-entry bookkeeping and vice-versa.

### 8.7. *Effective Date And Transitional Rules*<sup>295</sup>

The Act contains a number of transitional rules that recognize that a new system of taxation is replacing an older system. Since these rules are meaningful only by reference to the provisions of prior law, they are certainly beyond the scope of this Article.

## 9. ANALYSIS OF A POSSIBLE STRUCTURE FOR INVESTMENT IN THE CZECH REPUBLIC

Without tackling larger issues, it is nevertheless possible to draw some conclusions about the effect of the Act on foreign investment in the Czech Republic. Because this Article appears in a journal in the United States, these conclusions will focus on the activity of U.S. investors. In addition, the discussion will be limited to U.S. corporate investors since they are far more likely than other U.S. entities to invest in the Czech Republic.

It is a common practice in emerging economies to conduct business in the form of a joint venture between a participant from a developed economy who provides capital and know-how and a local participant who provides labor, facilities, and who makes the local arrangements. Moreover, requiring some investment and risk sharing from the local participant also strengthens the local participant's commitment to the venture. These joint ventures can take the form of either a partnership or a corporation under the Act.

Given the high rate of Czech tax on corporations,<sup>296</sup>

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<sup>294</sup> *Id.*

<sup>295</sup> *Id.* § 40.

<sup>296</sup> The Czech corporate tax rate is a flat 47% and applies to Czech companies and to income of a foreign company carrying out activities through a permanent establishment in Czech territory.

without some careful structuring, a U.S. corporation with Czech source income will probably pay more Czech tax on that income than would be creditable against its U.S. federal income tax.<sup>297</sup> It is possible, however, to structure around this problem.

If a U.S. corporation simply does business through a branch in the Czech Republic, the income from that business will be subject to tax at a 47% rate.<sup>298</sup> In general, this will exceed the corporation's U.S. rate by 12 percentage points resulting in 12 percentage points of non-creditable Czech tax.<sup>299</sup>

Similarly, if a U.S. corporation establishes a Czech subsidiary, funds that subsidiary entirely with equity and, accordingly, repatriates all of the profit in the form of dividends, there will be 12 percentage points of Czech tax that will not be creditable against the U.S. parent's U.S. federal income tax.

Instead, assume for example, that the subsidiary is funded with capital for only 20% of its requirements and is funded for

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<sup>297</sup> It is beyond the scope of this Article to set forth a detailed description of the U.S. system for crediting foreign taxes against the federal income taxes of a U.S. taxpayer. In general, a U.S. taxpayer can elect to have its federal income tax credited with the amount of any income taxes paid during the taxable year to any foreign country. I.R.C. § 901 (Supp. 1993). A U.S. corporation which owns 10% or more of the voting stock of a foreign corporation from which it receives dividends is deemed to have paid the same proportion of the foreign corporation's foreign income taxes as the amount of the dividends bears to the foreign corporation's undistributed earnings. I.R.C. § 902 (Supp. 1993). There is a limitation on the credit that is intended to prevent the credit of taxes imposed at a rate higher than the U.S. taxpayer's U.S. federal income tax rate. Under that limitation, the tax credit cannot exceed the same portion of the U.S. tax against which the credit is taken which the taxpayer's taxable income from sources outside the United States bears to the taxpayer's entire taxable income for the same taxable year. I.R.C. § 904(a) (Supp. 1993). These limitations are applied separately with respect to certain enumerated categories of income; however, dividends, interest, rents and royalties received from a wholly-owned foreign subsidiary engaged in an active business generally fall into a general category with most other kinds of business income. I.R.C. § 904(d)(3) (Supp. 1993).

<sup>298</sup> Under Article 7 of the U.S./C.R. Treaty, the Czech Republic can tax the profits attributable to the Czech permanent establishment of a U.S. corporation. See U.S./C.R. Treaty, *supra* note 16, art. 7.

<sup>299</sup> Section 13221 of the Omnibus Budget Reconciliation Act of 1993 generally increased the U.S. rate of corporate income tax to 35%. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13221, 107 Stat. 312 (codified at 26 U.S.C. § 11).

the remaining 80%<sup>300</sup> by a loan from its U.S. parent. In such case, the interest would ordinarily be deductible against the Czech tax<sup>301</sup> and the interest income to the U.S. parent would be free of Czech tax.<sup>302</sup> If the interest rate charged were anywhere near the profit rate of the Czech subsidiary (calculated on the total funding, including both the 20% of equity and the 80% of debt), the Czech tax would be fully creditable in the United States.

Because of the limitations under the Act on the amount of debt to related persons on which interest can be deducted, it may be necessary to use a license from the U.S. parent in addition to the debt. The royalty on the license of technology, trademark, or trade name from a U.S. licensor to a Czech licensee would generally be deductible by the Czech licensee and the licensor would be subject to only a 10% Czech tax.<sup>303</sup>

The conclusions drawn from the above example suggest that one tax efficient way for a U.S. investor to participate in a Czech joint venture is to form an entity that will be treated as a partnership under the Act; then have the U.S. investor, through a Czech subsidiary, become one of the partners. Further, the U.S. participant should fund the venture with as much debt as is permissible, and perhaps a license. These considerations should allow exploitation of the emerging Czech economy while minimizing the U.S. investor's total tax liability.

## 10. CONCLUSION

It is obviously difficult to predict how any sweeping tax legislation will work in practice, especially because the

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<sup>300</sup> The Act contains a rule to prevent the stripping of earnings from a Czech company to a related company through the use of debt. Under this rule, which is described *supra* note 248, interest would be nondeductible if the debt/equity ratio exceeded 1/4. Note that the equity in question is the Czech company's "registered capital."

<sup>301</sup> See Income Tax Act, *supra* note 2, § 24.

<sup>302</sup> Under Article 11 of the U.S./C.R. Treaty, interest from the Czech Republic received by a resident of the United States is free of Czech tax. See U.S./C.R. Treaty, *supra* note 16, art. 11. This rule does not apply to the extent that the purported interest is paid to a related party and exceeds the amount that would have been paid in the absence of the special relationship.

<sup>303</sup> The treaty limits to 10% the tax rate on these type of royalties. *Id.*

drafters of the legislation often have many items on their agendas. Unless all of those agenda items are made known, it may be only a guess as to whether the drafters' purposes were fulfilled.

Important criteria by which the legislation can be evaluated include:

- Does it raise the necessary revenue?
- Is it simple, fair and neutral?<sup>304</sup>
- It is sufficiently comprehensible and internally consistent so that the taxpayers can comply with it and the government can enforce it?
- Does it effectively mirror the ways in which economic activity takes place?<sup>305</sup>
- Does it alter or affect peoples' activity in ways that were not predicted and are not economically, socially, environmentally or culturally desirable?
- And, closely related to the preceding criterion, does the tax system discourage the kind of foreign investment that is necessary for the development of the economy?

Some of these issues are particularly difficult in an emerging market economy in which business and economic conventions and institutions are in their infancy. In such a case, the tax system may not only mirror the development of economic institutions but may also quite profoundly influence the development of those very institutions. Time will tell.

The analysis of the Czech income tax system continues. Accordingly, any conclusions that can be drawn from the Act will change as the Act is amended, as the Czech tax treaty network expands, and as those treaties themselves become effective. Nevertheless, given the potential of the Czech economy, it is important that we keep a watchful eye and persevere in our analysis of the Czech income tax and its implications for foreign investment.

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<sup>304</sup> The meaning of the terms "simple," "fair," and "neutral" in this context was described at the beginning of this Article.

<sup>305</sup> Whether a tax system effectively mirrors an economy depends, in part, on the drafters' understanding of the economy and the ways in which business is conducted. Given the flux of an economy making the transition from a socialist to a market based economy, such an understanding may be impossible.



Appendix  
SUMMARY OF WITHHOLDING TAX RATES

TYPE OF INCOME	DOMESTIC TAXPAYER	FOREIGN TAXPAYER
dividends, interest, etc. from securities & interests in companies, coops; general partner's profits in limited partnerships	25	25
silent partner profit	25	25
liquidation surplus & settlement amounts on withdrawal from company or coop	25	25
interest & other income from credits & loans, deposits & securities	N/A	25
interest from passbook & other similar deposits	15	15
income from commercial, technical etc. consulting, management or intermediary services in the C. R.	N/A	25
royalties on Intellectual Property	N/A	25
income of independent lecturers, artistes & athletes	N/A	25
rent without purchase option	N/A	25
rent with purchase option	N/A	1
emoluments of functionaries	20	20
prizes	15 or 20	15 or 20
interest earned by employees on deposits with employers	20	20
< 3000 crowns/month of authors for magazines, newspapers, radio & TV	10	10

Income Tax Act, *supra* note 2, *passim*.