1-1-1992

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Andrew C. Fiala
Lehigh University

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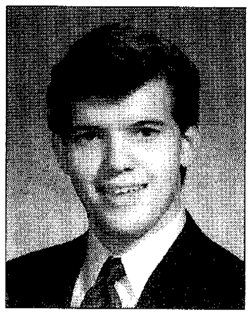

Introduction

As Czechoslovakia has freed itself from communism, the nation has opened up to the West. With this new openness, Czechoslovakia is free to trade with the United States as well as with other European nations. Among the many practical challenges Czechoslovakia faces in trading with these countries is the adaptation of the nation's system of accounting so that it is compatible with that of the West.

Before 1989, Czechoslovakia had little motivation to match its accounting standards with those of Western countries such as the United States, Germany, or France. The communist government owned all industry and engaged in limited trade with the West. When an industry encountered financial loss, the government often subsidized the struggling company with additional funds. Management was concerned primarily with meeting production quotas. The role of accounting was to keep record of and prepare statements documenting two activities: 1) the location and worth, if any, of assets and 2) the source (subsidies and revenues) and uses (expenditures) of money. This accounting information was for the use of centralized ministries, which relied primarily on short-term planning. (Bailey, p. 78) The management of a particular company received only minimal economic information; even this information was superfluous, however, since planning was a function of the ministries, not of individual management teams. (Bailey, pp. 15, 23)

Now many Western companies are interested in entering joint ventures with or acquiring Czechoslovak businesses. These Western European and American firms are not willing to make an investment, however, unless they know the actual economic status of the companies with which they are considering a joint venture or purchase. Because Czechoslovak accounting standards and practices are incompatible with Western procedures, both parties face a dilemma. The Czechoslovak financial statements have to be converted into a Western format, whether according to generally accepted international or American accounting principles (GAAP) or some other nation's accounting principles. Furthermore, Western companies need to know the future prospects of the Czechoslovak firms.

At this point in time, then, the Czechoslovak accounting profession faces two imposing challenges. First, the government and the accounting profession must develop both a new and effective accounting system and tax standards that are compatible with those in the West. Second, while developing these standards and accompanying procedures, Czechoslovak companies must cooperate with both Czechoslovak and Western accounting firms to convert their financial statements so that Western firms can understand and utilize them. Fulfilling these immediate needs while developing a comprehensive, long-term accounting policy will allow Czechoslovakia to progress towards a market economy as quickly as possible.

In this paper I will provide an overview of the accounting system and tax standards as they currently exist. I will examine Czechoslovak procedures in terms of both corporate and individual taxation. Finally, while explaining the accounting system and tax standards, I will demonstrate differences between procedures in Czechoslovakia and in the United States.

Standards

Czechoslovak accounting procedures are currently determined by the government. Unlike Western GAAP, Czechoslovak procedures do not utilize general concepts of proper accounting principles. Rather, Czechoslovak procedures are a set of strictly regimented and specialized rules. For example, the rules dictate for a given transaction which account should be debited and which should be credited. In fact, according to one American certified public accountant now practicing in Czechoslovakia, the elaborate standards are so confusing to Western accountants that the brown book explaining the standards has been called "the Brown Bible." (Zeleznik) Because of the lack of accounting concepts, Westerners have a difficult time interpreting accounting rules that do not correlate with Western practice.

One area of significant discrepancy between Czechoslovak and Western accounting practice is the valuation of tangible assets. Historical cost (the purchase or manufacturing cost) is the basis for the value of assets. Determining the current value, however, is more difficult. Straight-line depreciation rates, set by the Federal Ministry of Finance in accordance with the original value, vary with each class of asset, such as buildings or office equipment. (Antrobus, p. 5; Coopers & Lybrand, p. C-102) For each asset category, then, the depreciation rate also varies. For example, buildings may be depreciated at a rate ranging from 1 to 5 percent while office equipment is depreciated at a rate between 6 and 20 percent. (Antrobus, p. 5) Even after figuring the carrying value of an asset (the purchase or manufacturing cost less depreciation), Czechoslovak companies do not necessarily book those assets. Consequently, only appraisers who are familiar with such capital assets can provide Western companies with an accurate valuation of a Czechoslovak company's assets.

The treatment of receivables is another area of disagreement between Czechoslovak and Western standards. Like the United States, Czechoslovak accounting procedure does allow for the establishment of bad debt reserves. In fact, some companies have reserves that vary from 50 to 80 percent of their receivables. (Zeleznik) Bad debt, however, cannot be written off until the company recording the receivable is declared bankrupt. (Zeleznik) In contrast, American companies may write off and recognize a deduction for bad debt in the year in which the receivable becomes worthless.

Corporate Income Tax

Determination of Taxable Income

Tax issues also vary significantly between the West and Czechoslovakia. Taxable income is not computed according to Western international accounting standards. Instead, corporation tax is computed according to the net income reported on annual financial statements, which is determined after deductible expenses. (DRT International, p. 64) American firms, on the other hand, calculate taxable income after both exclusions and exemptions. Unlike Western standards, Czechoslovak rules do not allow for accruals, so Czechoslovak companies cannot reduce income with provisions for stock obsolescence or warranty reserves. (Antrobus, p. 4) Thus, since Czechoslovak methods allow for neither exclusions nor accruals when determining taxable income, taxable income for a given company will be higher in Czechoslovakia than it would be in the United States.

Furthermore, resident entities, Czechoslovak companies operating in Czechoslovakia, are taxed on their worldwide income (Antrobus, p. 4) while nonresident entities, such as foreign companies with commercial representation in Czechoslovakia, are taxed only on income from distinct Czechoslovak enterprises or from Czechoslovak sources (i.e., dividends, interest, and royalties). (Coopers & Lybrand, p. C-98; DRT International, p. 66) In some situations involving foreign capital, income is not based on distinct activities in Czechoslovakia, but rather on an estimated profit equal to 30 percent of the total salary costs incurred by the foreign entity in Czechoslovakia. (Antrobus, p. 4)

When determining net income, Czechoslovak companies must include capital gains, but may deduct most expenses incurred in conducting their activities, including social security payments, interest, and allowances for depreciable assets. Certain expenses, however, are not deductible. The Czechoslovak tax code does not allow an investment allowance or a deduction for dividends paid. While American companies can deduct salary expenses, Czechoslovak businesses may not deduct salary expenses. Also, costs for which the business is not liable according to appropriate regulations may not be deducted. Finally, Czechoslovak tax standards disallow the deduction of entertainment and personal expenses, donations, and fines and penalties; the United States tax code generally allows deduction of these expenses within established limits.

Currently, Czechoslovak tax law does not allow for the carryforward or the carryback of losses against the profit of other years. Corporations in the United States can carry a net operating loss back three years or forward fifteen years. By the year 1993, tax reform in Czechoslovakia, however, is expected to provide for a limited carryforward plan. (Antrobus, p. 4) For each of the three years following the loss, 33 1/3 percent of the loss would be carried forward. (Coopers & Lybrand, p. C-103)

Tax Rates

Once net income is determined, the tax rate imposed depends upon the type of entity. Resident entities, or those that are wholly Czechoslovak, are subject to a tax rate of 20 percent on profits up to 200,000 Czech korunas and 55 percent on profits in excess of that figure. Banks still must pay a tax of 65 percent, which was the rate applicable to all Czechoslovak companies until 1991. (KPMG, *Czechoslovakia...*, p. 19) Through 1990 state-owned enterprises paid 75 percent of their profits to the government. The distinctly Czechoslovak income of foreign companies with representation in Czechoslovakia is taxed at 40 percent. (DRT International, p. 66)

Joint ventures are subject to a separate tax structure. If more than 30 percent of a company's capital is provided by a foreign party, then the entity is subject to a tax of 20 percent on the first 200,000 korunas of profits and 40 percent on the excess profits. (Coopers & Lybrand, p. C-97) If foreign participation is less than 30 percent, however, then the company is treated as a resident entity subject to the progressive rates of 20 percent and 55 percent.

While Czechoslovak tax law distinguishes among enterprises based on their ownership and sources of income, the United States does not. The United States tax code imposes a tax on both the foreign and domestic source income of both domestic and foreign-owned corporations. Like the Czechoslovak tax structure, though, American corporate taxes are also based on a progressive structure with rates ranging from 15 to 39 percent.

Other Taxes on Corporations

Czechoslovak entities are also subject to withholding taxes on payments, such as dividends or royalties, made to entities outside Czechoslovakia. Rental payments on industrial equipment, dividends, interest, and copyright royalties are subject to a 25 percent withholding tax, while the tax on industrial royalties is 35 percent. A 30 percent tax is levied on payments for technical assistance and services from abroad.

Czechoslovakia has entered into tax treaties with many countries in which each country agrees to reduce withholding tax rates. Under the treaty provisions, dividends are subject to rates between 5 and 15 percent. Withholding rates on interest payments may range from 0 to 15 percent. Finally, the tax treaties reduce tax rates on industrial royalties to 5 to 15 percent.

In addition to the withholding tax, all manufacturers of goods for Czechoslovak consumption must pay a turnover tax based on the sales price of the goods. Only goods for export and particular basic goods and services for domestic use are exempt from the turnover tax. Suppliers of consumer goods must also pay the turnover tax if the goods have not already been subject to the tax.

The turnover tax structure was drastically simplified in 1991. Although there were once 2,000 separate rates, only four rates now apply. First, basic foodstuffs, fuel and energy, and all exports are exempt from the turnover tax. Building materials are subject to an 11 percent tax, while most manufactured goods are taxed at 20 percent. Finally, a 29 percent turnover tax is withheld on regular consumer goods such as cars, clothing, and cosmetics. Just as some luxury items in the U.S. are taxed at a higher rate (10 percent of the sales price in excess of the particular threshold price for each class of item), so too are Czechoslovak luxury consumer goods subject to special rates. Even though the turnover tax has been simplified, by 1993 it will be replaced by a conventional value-added tax like those found in other European countries.

Individual Income Tax

Determination of Taxable Income

The determination of individual income subject to income tax depends on whether the employer is a Czechoslovak company or a foreign company. If the employer is a Czechoslovak company, most compensation both in cash and in kind is taxable. Certain payments, however, are exempt; such exemptions include sickness and termination benefits, scholarships, incentive awards, and reimbursement for business, travel, and relocation expenses. On the other hand, only cash compensation is taxable if the employer is a foreign entity. (Antrobus, p. 6)

Tax Rates

Both foreign and Czechoslovak employees of any Czechoslovak company are subject to a progressive individual income tax. Individual rates, which range from 5 to 32 percent, are determined by the taxpayer's age, sex, and number of dependents. (Coopers & Lybrand, p. C-99) Unlike the American tax code, the Czechoslovak tax code does not allow for aggregation of family income. In other words, each wage-earner pays taxes as if he or she were the sole supporter of his or her family. Czechoslovak individuals do not have the option of filing their returns and determining their tax liability jointly.

A foreign employee who resides in Czechoslovakia for more than 183 days of the year is considered a resident; and his or her entire income, from both Czechoslovak and foreign entities, is subject to Czechoslovak taxes. For such employees, however, a Czechoslovak tax credit is provided for foreign taxes paid on income that is also taxed in Czechoslovakia. Non-resident foreign employees are only subject to tax on income from Czechoslovak entities. (Antrobus, p. 5)

A foreign employee paid by a foreign company in Czechoslovakia is subject to a separate income tax, regardless of whether the employee is a resident or non-resident. Czechoslovak tax law imposes a 17 percent tax on income attributable to duties performed in Czechoslovakia. The foreign company withholds the tax from its employees and is required to pay this tax every month, subject to the provisions of any double tax treaty. Finally, Czechoslovak employees of foreign companies are subject to the same progressive wage tax as Czechoslovak employees of Czechoslovak entities. (Antrobus, p. 5)

Income from literary and artistic work and performances in excess of 50,000 korunas and not paid by a company (e.g., self-employment income) is also subject to progressive income taxes ranging from 3 to 33 percent. (Coopers & Lybrand, p. C-99) In this case the individual must file a tax return to account for the income. Taxable income is based on income for the year less allowable deductions. Expenses associated with the creation of the literary or artistic work are deductible in amounts ranging from 20 to 60 percent of gross income, depending on the nature of the work. (DRT International, p. 69) Also, each of the taxpayer's dependents warrants an exemption of 7,800 korunas. Contributions to cultural funds are deductible, but, like U.S. tax law which limits to 3 percent the amount of deductions for taxpayers with income above a certain threshold, are limited to 2 percent of gross income.

Other Taxes on the Individual

As in the United States, the Czechoslovak employer is responsible for withholding income taxes based on each employee's salary. Czechoslovak individuals, therefore, do not have to file tax returns if their sole income is received in cash from the employer. While companies in the United States also withhold taxes, employees must still file income tax returns.

Employers are also obligated to make contributions to the social security funds for their employees. Czechoslovak companies pay a social security tax equal to 50 percent of the payroll. (Coopers & Lybrand, p. C-102) Certain service industries, including tourism, hotels, and car repairs, are allowed a reduced rate of 20 percent. (Coopers & Lybrand, p. C-102) Foreign entities pay a 10 percent social security tax on Czechoslovak employees only. Social security tax payments are deductible for business income tax purposes. (Antrobus, p. 6)

In addition to taxes based on income, Czechoslovaks who own structures are also subject to a house tax on the rental value of such property. The value of a family home is determined by the size of the developed area. Depending on the location and quality of the home, tax rates vary from 0.80 to 7.5 korunas per square meter. (DRT International, p. 70) For other buildings the tax is based on the rental income received, less deductible expenses. When the taxable base is less than 6,000 korunas, the tax is 45 percent; but when the base is above 6,000 korunas, the tax is 50 percent. Czechoslovaks who use farm land must also pay a tax at a rate up to 3,000 korunas per hectare of land, depending on the climate, soil, and terrain. (DRT International, p. 73)

Czechoslovak tax law imposes an inheritance tax on the recipient of property by inheritance or by gift from the deceased in the three months preceding death. (Coopers & Lybrand, p. C-102) Moveable assets worth less than 50,000 korunas and savings accounts, however, are exempt from inheritance taxes. (DRT International, p. 74) The tax rate varies depending on the value of the property and on the relationship between the deceased and the recipient; the size of the estate or gift is not critical in determining tax liability. (Coopers & Lybrand, p. C-102) Spouses, children, grandchildren, and parents pay a 1 percent tax. Siblings and adult offspring who have lived with a parent for at least one year are subject to a 5 percent rate. All other recipients must pay an inheritance tax equal to 20 percent of the property. The reforms of Czechoslovak tax law will include new inheritance and gift taxes.

Payment of Taxes

Czechoslovak taxpayers, both businesses and individuals, use the calendar year for tax purposes. While most American individuals base their tax year on the calendar year, American corporations are granted flexibility in selecting their tax year. Unlike their American counterparts, Czechoslovak companies may not elect an alternate financial year end. (Antrobus, p. 3)

In Czechoslovakia, taxes must be paid within 15 days of the final assessment; sometimes, however, taxes (such as individual income taxes) are withheld when income is first received. Just as many Americans remit estimated tax payments in the United States, Czechoslovak taxpayers may also be required to make partial payments of their projected tax liability in advance of the final assessment.

Conclusion

The Czechoslovak system of tax and accounting standards is not as comprehensive as that of the United States and Western European countries. Yet, significant similarities exist which may prove to be the basis for the development of a more thorough system. The

Czechoslovak government promises to introduce additional legislation and tax rules in 1993, which are sure to bring Czechoslovakia closer in line with those of the West. Until that time, Czechoslovak companies and their Western counterparts will have to rely on professional accounting, auditing, and tax firms to keep the privatization and market economy functional and compatible with the West.

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