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Tax Reform in the Czech Republic

Introduction

The Czech Republic has introduced comprehensive tax reforms with effect from 1 January 2008 as part of a major public finance reform package. The tax reforms, which represent a general shift from direct taxation to indirect taxation, include corporate, individual, energy, excise, real estate, inheritance, gift and VAT tax measures, as well as provisions regarding binding tax rulings and reserves.

Background

Due to the unsustainable state of Czech public finances, the new government, which took office in January 2007, introduced a reform package aimed at medium-term fiscal consolidation of its finances. An important part of the package is tax reform. The public finance reform is intended to eliminate excessive government deficit and gradually lead towards long-term sustainability of public finances, as a stable macroeconomic environment is a vital factor in promoting economic growth. The measures will become effective 1 January 2008. They introduce dramatic changes in the tax system of the Czech Republic. Areas of legislation that will be affected by the changes include, among others, the Income Tax Act, the Act on Reserves, the Real Estate Tax Act, the Excise Tax Act and the Gift, Inheritance and Real Estate Transfer Tax Act. The reform package also introduces three new tax acts that implement into the Czech tax system the EC Energy Taxation Directive.[1]

The tax measures are aimed mainly at promoting economic growth and employment. The tax burden is gradually being shifted from direct to indirect taxes. For example, an increase in VAT and excise taxes on tobacco and new energy taxes will be compensated for by a substantial cut in personal and corporate income taxes.

Income Taxation

The Amendment to the Income Tax Act provides for a gradual reduction of the corporate income tax rate, implements a single personal income tax rate (flat tax) and broadens the tax base for both corporate and personal income taxes. In addition, the amendment brings technical and other changes.

Corporate Income Taxation

Introductory remarks

The corporate tax rate will be gradually reduced from 24% in 2007 to 21% for tax periods starting in 2008, 20% in 2009 and 19% in 2010. The proposed amendment links the application of the new tax rate to the beginning of the taxation period, in contrast to the current system, which links the tax rate to the last day of the taxation period. The withholding tax rate will be a general uniform rate of 15% from 2008 and 12.5% from 2009. These cuts in tax rates will be accompanied by a broadening of the tax base that should secure budget stability in connection with the proposed decrease in the income tax rate.

Participation exemption

The participation exemption granted by the EC Parent-Subsidiary Directive[2] will be broadened to cover dividends received from subsidiaries that are tax residents in non-Member States. Capital gains from the sale of shares in a subsidiary will also be exempt from corporate income tax provided certain conditions are met. These conditions are similar to those suggested in the EC Parent-Subsidiary Directive. If the income comes from a non-Member State, the source country has to be a country with which the Czech Republic has concluded a tax treaty, and the subsidiary has to be subject to a minimum corporate income tax rate of 12%.

Deductibility of financial costs

Thin capitalization rules and restrictions on the deduction of financial expenses will be stricter as of 2008. The ratio of the amount of loans and credit from related parties to equity will be reduced to 2:1 (3:1 for banks) from the current level of 4:1. The debt-equity ratio for credit and loans provided by non-related parties will be 6:1 for 2008 and 4:1 for the following years. The amendment introduces the term "financial costs from credit and loans", which, in addition to interest from credit and loans, includes costs relating to obtaining and processing credit and loans, as well as fees for guarantees. The financial costs of loans and credit in excess of the ratios mentioned above will no longer be tax deductible.

In addition to the changes related to thin capitalization, the rules governing "arm's length" interest rates on loans from related parties in the amount of 140% of the discount rate of the Czech National Bank (or lower in some cases) will be eliminated starting in 2008.

Furthermore, a maximum limit for tax-deductible costs from credit and loans has been introduced, which equals a uniform interest rate plus an additional 4 percentage points. The uniform interest rate is the average of the ref-

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1. 2003/96/EC.
2. 90/435/EEC.

erence balance of interest rates on the interbank deposit market for a 12- month maturity relevant for the currency in which the credit or loan is denominated as of the last day of each month of the taxable period, or the period for which the tax return is filed. The limit for tax-deductible costs from credit and loans is calculated based on the average amount of the credit and loans actually drawn. The limit covers interest costs and related financial costs. Financial costs exceeding this limit in the taxable period will be considered tax-non-deductible costs. This rule will not apply to interest paid by individuals and interest paid to non-related parties that does not exceed CZK 1 million in the taxation period. Financial costs from credit and loans subordinated to other payables are to be tax-non-deductible. Furthermore, financial costs from credit and loans are to be tax-non-deductible if their amount or maturity is dependent on the economic result of the debtor.

The new rules on the tax deductibility of financial costs will come into effect for contracts concluded after 1 January 2008 and for amendments to existing contracts modifying the amount of loans/credit and interest that will be concluded after 1 January 2008. Beginning 1 January 2010 the rules will apply to all loans and credit.

Financial leases

Further to the stricter limits on the tax deductibility of interest, the amendment to the Income Tax Act restricts the tax deductibility of financial lease payments to a maximum of 99% of the total amount. The non-tax deductible 1% of the lease amounts represents a "hidden" interest/financial cost that is generally included in lease payments and does not enter into the calculation of thin capitalization. This restriction is valid only for the financial costs of lease payments exceeding CZK 1 million in a taxable period. This change will therefore only affect a limited number of taxpayers.

The amendment to the Income Tax Act has introduced other changes in regards to the treatment of financial leases as a tax-deductible expense. The amendment unifies, for tax purposes, the minimum duration of financial leases related to movable assets and the minimum depreciation period. The minimum duration of financial leases for real estate has been increased from the current eight years to 30 years. These changes, in essence, abolish the current tax advantages of financial leasing. The amendment also raises the withholding tax rate for lease payments abroad to 5% from the current level of 1%. The transition provisions stipulate that existing measures apply to financial leasing agreements concluded up to 31 December 2007.

Depreciation of assets

The depreciation category 1a has been eliminated, and passenger cars and vans (N1-type automobiles) will be depreciated in the second depreciation group for a period of five years. This change does not affect automobiles acquired before 1 January 2008. In connection with this change, the limit for making use of depreciation of a passenger car for tax purposes, currently CZK 1.5 million, will be cancelled. Generally, passenger cars that are recorded as assets starting from 1 January 2008, will be subject to depreciation for tax purposes based on the full acquisition cost if the general conditions are met (i.e. the car is used for the purpose of acquiring, securing and maintaining income).

Additional changes

The amendment to the Income Tax Act covers a number of other changes including the following:

– the special limitation on the tax deductibility of expenses relating to employee pension and private life insurance plans, the transfer of employees to work and temporary accommodation has been eliminated. In-kind benefits provided by employers to their employees such as sports, cultural and educational facilities, as well as other company recreation (up to CZK 20,000 per annum), and non-alcoholic beverages at work are, in general, considered non-deductible expenses. The provision of recreation and holidays, or similar trips, may, however, be deemed a tax-deductible expense of the employer in circumstances where the provision of these benefits is properly regulated under internal company rules, a collective agreement or an employment contract. In this event, the in-kind benefits cannot be tax exempt at the employee level and will be subject to mandatory social and health insurance contributions. Company-provided catering continues to be tax deductible up to certain limits and is not subject to personal income tax or mandatory contributions;
– debtors will be obliged to increase their tax base by the amount of an outstanding payable corresponding to a receivable that is more than 36 months overdue or is statute-barred. There is a similar provision for individuals: however, for individuals, the provision also covers liabilities that did not decrease the tax base in the past. If the debt is paid in the following taxable period, the tax base can be reduced by that amount;
– the current tax exemption for mortgage-backed securities (mortgage bonds) has been eliminated for both legal entities and individuals. Mortgage bonds issued prior to 31 December 2007 are not affected; and
– the bill implements the EC Merger Directive[3] as amended and includes provisions on partial division (split-off);
– the amendment specifies the tax deductibility for damage incurred due to proven disposal of inventories of past due material, semi-finished products and finished products. It will be necessary to present evidence of the disposal of the inventories.

3. 2005/19/EC.

Personal Income Taxation

A single (flat) individual income tax rate of 15% will be introduced effective 1 January 2008. From 2009 the tax rate will be further reduced to 12.5%. The tax base of an employee will include the employee's gross salary, as well as the health and social insurance contributions payable by the employer (35% of gross salary). The employee's contributions (12.5% of gross salary) will no longer reduce the tax base. In essence, the effective rate will be approximately 23% of the present tax base applicable to an employee's income.

Self-employed individuals will not be able to deduct their mandatory social and health insurance contributions from their tax base. Similarly, such costs paid by a general partnership on behalf of its partners and by a limited partnership on behalf of its general partners will no longer be treated as tax deductible.

The withholding tax rate will be standardized at 15% from 2008 and 12.5% from 2009.

Tax credits will be significantly increased from 1 January 2008 as follows:
- from CZK 7,200 to CZK 24,840 for an individual taxpayer;
- from CZK 4,200 to CZK 24,840 for a dependent spouse;
- from CZK 2,520 to CZK 16,140 for a holder of a medical disability card;
- from CZK 2,400 to CZK 4,020 for students;
- from CZK 6,000 to CZK 10,680 per dependent child; and
- from CZK 0 to CZK 24,840 for a retired person.

A tax refund of the dependent child tax credit of up to CZK 52,200 can be claimed provided the tax payable is lower than the tax credit. This increase in tax credits is necessary in order to prevent an increase in the tax burden of those who are currently taxed at rates below 23% or of spouses previously subject to joint taxation (income splitting), a provision that will now be abolished. In connection with the lowering of the tax rate to 12.5% starting in 2009, the tax credits will also be decreased. Because such a decrease will increase the tax burden of the majority of taxpayers in 2009 in comparison to 2008, it is likely that the tax credits will be further amended in 2008. In addition, the minimum tax base for private entrepreneurs will be abolished.

The income tax exemption for income earned from the sale of securities, provided that the security has been owned by the individual for more than six months, will continue to apply to publicly traded securities and other investment instruments and collective investment securities (for example, unit certificates). A further condition for exemption is that the seller does not control (directly or indirectly) share capital or voting rights exceeding 5% in the 24 months preceding the sale. For other securities (for example, shares that are not publicly traded), the holding period will be extended to five years. The current legislation will apply to the sale of securities acquired before the end of 2007.

The tax exemption for temporary accommodation of employees will be limited to CZK 3,500 per month. Further, the amendment introduces a tax exemption limit for contributions made by an employer on behalf of an employee to additional pension and life insurance. The exemption limit is CZK 24,000 per annum in respect of the total of pension insurance contributions, the state contribution and private life insurance contributions.

New Binding Tax Rulings

The reform package introduces five new areas in which binding tax rulings can be obtained from the competent tax authority:
(1) an allocation method for expenses linked to both taxable and non-taxable income;
(2) the determination of the ratio between expenses related to the operation of real estate used partly for business activities and partly for private purposes;
(3) the determination as to whether or not costs can be capitalized as a capital improvement of the asset or be expensed as repair or maintenance;
(4) the determination as to whether or not certain expenses incurred during implementation of research and development projects qualify for a tax allowance; and
(5) guidelines for determining whether a taxable supply is subject to the standard or reduced VAT rate.

A fee of CZK 10,000 will be imposed for each request for a ruling.

Act on Reserves

The tax reform package contains several important changes to the Act on Reserves. Stricter conditions for creating tax-deductible provisions for receivables (bad debts) over CZK 200,000 have been introduced. These receivables can be provisioned for tax purposes only if arbitration, court or administrative proceedings are in progress. Receivables under CZK 200,000 continue to be subject to the current system, i.e. can be provisioned for tax purposes at a rate of 20% of the outstanding receivable that is not subject to legal collection and over 20% if the receivable is subject to legal collection, as of the date the receivable became overdue. This measure will be in effect for provisions that were created after 1 January 2008.

A minor change has also been introduced in insurance-related technical reserves. Starting from 2008, technical reserves of both life and non-life insurance and equalization reserves of non-life insurance are to be tax-non-deductible. The balance of these reserves recorded on 1 January 2008 is to be used up in the tax period starting in 2008.

VAT

The reduced VAT rate will increase from 5% to 9%. This rate applies, in particular, to foodstuffs, medicines, residential construction, accommodation and passenger transport. In order to encourage environmentally friendly behaviour, certain commodities (for example, firewood) will be taxed at a reduced rate. The standard rate will remain 19%.

With respect to the new energy taxes that will be implemented in 2008, the amendment stipulates that these taxes will be included in the VAT base.

The VAT Act amendment introduces the option of VAT grouping. A VAT group generally consists of related entities with an address, a place of business or a branch in the Czech Republic. VAT grouping potentially simplifies administrative procedures related to filing VAT returns within group companies and optimizes non-recoverable VAT due to stewardship and overhead costs and intra-group VAT non-taxable turnover. Each member of the VAT group is jointly and severally liable for the VAT debts of the whole group. VAT grouping offers limited flexibility with regard to restructuring. Group companies that register as a single VAT entity by 31 October of the current year become a VAT group effective 1 January of the following year. The VAT group is then treated, for VAT purposes, as a single entity, i.e. only transactions with non-group members are subject to VAT. All the rules applicable to a VAT payer are applicable to the VAT group as a single entity. VAT grouping is not compulsory.

The reform package also implements a new definition of "social housing". Residential construction that meets the definition of "social housing" will continue to enjoy a reduced VAT rate. Alongside accommodation facilities for socially disadvantaged persons and certain other groups, "social housing" will include family houses with floor space of up to 350 m^2 and apartments of up to 120 m^2.

The amendment further includes a reduced VAT rate for construction and assembly work related to the repair and modernization of previously constructed apartments, apartment buildings and family houses. The provision will only have effect until 31 December 2010.

Real Estate Tax

Farm land (arable land, hop gardens, vineyards, fruit orchards and permanent grasslands) may be exempted from the real estate tax subject to the discretion of the appropriate municipality. Furthermore, municipalities will be allowed to determine local coefficients (2, 3, 4 or 5) by which they can increase the taxpayer's tax liability on real estate in the local cadastral territory. This measure should help the municipalities maintain their budgetary tax income at the same level of their tax revenues if they decide to exempt the farm land.

Real Estate Transfer Tax, Inheritance Tax and Gift Tax

The exemption from inheritance tax is extended to persons belonging to Group II. Persons in Group I are already exempt. Group I includes immediate family members (parents, children) and spouses. Group II includes extended family, for example siblings, nephews, nieces, aunts, uncles, etc. The amendment introduces tax exemptions from gift tax on gifts among persons in Group I and Group II.

The establishment of an easement or similar right for no consideration in favour of the donor in the event of a donation of real estate is no longer subject to real estate transfer tax, but rather to gift tax.

The amendment also specifies that acquisitions of property, on the basis of a contract securing transfer of the debtor's right in favour of the creditor, is subject to real estate transfer tax.

Energy Taxes

Under transition rules, that have applied to the Czech Republic since its accession to the European Union, the Czech Republic is required to implement EC law regarding the taxation of harmful consumption of natural resources[4] by 1 January 2008. New taxes on electricity, solid fuels and natural and other gases are being introduced in the form of three new acts included in the tax reform package. These new taxes will lead to a further increase in the proportion of indirect taxes.

The approved rates are set out in the table below:

Product	Excise tax (in CZK)
Electricity (per MWh)	28.30
Natural gas (per MWh)	30.60
CNG (per MWh)	0 (increases from 2012 up to 264.80 in 2020)
Coal (per GJ)	8.50

Various exemptions from and reductions of the energy taxes are included in the three new acts, i.e. an exemption of households from taxes on natural gas, energy products and electricity used to produce electricity, and an exemption for electricity produced by environmentally friendly methods.

Excise Taxes

The tax reform package also includes an amendment to the Excise Tax Act. The most important change is an increase in excise tax on tobacco products. The intention is to reach at least the minimum excise tax rates applicable in the European Union (Directives 92/79/EEC and 92/80/EEC). The full implementation of the Directives has been postponed to 1 January 2008 under the transition rules applicable to the Czech Republic as a result of its accession to the European Union. The amendment to the Excise Tax Act abolishes the preferential taxation of waste oils and some biofuels.

Tax Administration

In order to decrease administrative burden, the obligation to register cash payments using cash registers with fiscal memory and other related obligations will be elim-

4. Energy Taxation Directive, 2003/96/EC.

inated. The businesses concerned (retail establishments and restaurants) will only be subject to standard accounting and reporting rules.

Mandatory Social Security and Health Care Contributions

Effective 1 January 2008, the assessment base for calculating the mandatory contributions to the social security and health care system will be capped at four times the average monthly salary (approximately CZK 80,000). This measure will significantly reduce the extremely high burden on employers and employees with respect to high-income earners. Furthermore, the same cap will also be used where an individual receives income from entrepreneurial activities or both income from entrepreneurial activities and employment.

The assessment base for calculating the mandatory contributions has been slightly redefined. Based on the new definition, the "usual price" will be used for benefits in kind provided to employees instead of "cost accounted for". That means that even the provision of a company car for both business and private use by the employee will be subject to mandatory contributions.

The group of individuals subject to mandatory health care insurance has been redefined. All individuals who have or should have income from dependent activities under the Income Tax Act are, in general, considered employees. This means that even members of statutory boards, procurists, liquidators, etc. will be subject to mandatory contributions to health care insurance.

The implementation of the amended sickness insurance law has been postponed from 2008 to 2009. This means that the so-called contractual and foreign-employee concept, which will ensure that a higher percentage of foreign persons will be subject to the insurance payments, will be applied from 2009. Foreign persons include employees of employers with their seat outside the European Union and outside countries that have a social security treaty with the Czech Republic. Finally, sickness benefits will be suspended, as of 2008, during the first three days of illness.