Prague University of Economics and Business
Department of Public Finance

Texts for "Taxation in the CR and EU"

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Preface

Dear students:

Thank you for spending time with this textbook; by reading this preface, we hope you will also work with some of the texts inside.

We started to lecture the intermediate course of taxation in English at the Prague University of Economics and Business. We soon realised there were no suitable texts for students new to the taxation field and its related English terminology.

The presented texts aim to serve mainly as elementary material for students of the related courses and associated lectures. We aim to provide you with basic grounds for your presentations and extensive in-class discussions as a follow-up to the lectured part of the course. As authors and lecturers, we consider the ability to adequately explain and argue the relevant topics to be the key skills for our students to practice and master. The best approach to the course material is to devote an hour (or so) to the relevant text before each lecture and get back to any issues that are still not fully clear shortly after the lecture. This way, after concluding the full run of the course, it is possible to acquire a good knowledge of the basic tax terms for each topic and the ability to use it further (in literature reviews, final theses, scientific papers, etc.).

Students in our classes are Czechs with elementary knowledge of the Czech tax system but a limited understanding of English tax terminology, and international students with good English skills but almost no familiarity with the Czech tax system. The presented textbook thus mainly strives to deliver the tax topics in an accessible manner to both these groups.

Nevertheless, we believe this textbook may also serve other students who want to improve their understanding of English tax terminology and enhance their knowledge of the Czech tax system in the context of European and international taxation even when not attending the related courses.

We look forward to meeting you in the class or on other occasions.

Yours faithfully,

Jana Tepperová & Hana Zídková

1. Introduction to Taxation

This chapter presents basic terms used in the tax theory and policy, along with the definition of tax and a list of objectives and desirable characteristics of a tax system.

Basic terms

Tax is a monetary, mandatory, non-equivalent, and non-specific charge or other levy imposed on a taxpayer by a state. Tax is implemented by law. Failing to pay taxes is punishable by law. Taxes can be paid regularly or occasionally based on certain conditions stipulated by the tax legislation.

The non-equivalence of taxes means that the taxpayer receives nothing specific in return for paying the taxes. Taxpayers do not acquire services or benefits equivalent to the taxpayer's contribution to the state budget.

The tax receipts are used for various purposes without prior determination of how the particular tax payment is assigned. Therefore, taxes are **non-specific charges**.

Customs duties are also classified as taxes, as they are paid on imports of goods based on the customs legislation. They are enforceable by law and form a part of the state budget revenues.

Health insurance and social security contributions are also considered taxes by the OECD classification, although these are not strictly non-equivalent. Participants in the social and health insurance national schemes are entitled to sickness allowances, pensions, and healthcare, as needed.

Duty is a charge for services the public sector provides, such as issuing a passport. In contrast to taxes, **duties are equivalent and specific**. This means such levies are used by the public bodies to cover the costs of providing something specific. Similar to taxes, duties are **irrecoverable**. They are usually not paid regularly and, in most cases, generate revenues for the local authorities' budgets. The duty paid for keeping a dog could serve as an example.

Classification of taxes

Taxes are either **direct** or **indirect** depending on how they are linked to the taxpayer's income, consumption, expenditure, or property. The tax can be classified as direct if it is paid directly from the taxpayer's income (property). Furthermore, it is assumed that **direct taxes** are not generally shifted to other taxpayers. Examples of direct taxes include income taxes or taxes imposed on the ownership or transfers of property (e.g., real estate tax, tax from the acquisition of real estate, road tax).

In contrast, **indirect taxes** are supposed to be paid from the price charged by a taxpayer to its customer(s). Tax burden (i.e., the real economic cost of tax) is effectively born by the customer and not by the taxpayer, who only collects the tax for the government. Examples of indirect taxes include VAT or excise duties.

Taxes can be imposed on various **tax bases**. The most common is the personal or corporate **income**, capital assets, or generally speaking **property** of the taxpayer as well as **consumption**. These taxes differ in their progressivity and effectiveness. These characteristics will be discussed in the following sections.

Objectives of taxation

Taxes are used to support the basic functions of the public sector. These functions include the **allocation of resources**, **redistribution of income**, **stabilisation of the economy**, and **regulation of businesses**.

The main objective of taxation is the so-called **fiscal function**. Taxes represent a significant source of revenue to the state budget. Tax revenues enable the government to cover public spending and thus fulfill its **allocation function**. Public money is usually spent in the areas where private investments are less common or public support is desirable (e.g., education). Tax revenues are also used to provide services supplied exclusively by the state (e.g., defense). Furthermore, taxes are also **redistributed** to ensure a more equitable allocation of income in society.

However, taxes also represent a powerful tool for regulating businesses; for example, they can help protect the environment. Ecological (environmental) taxes can be imposed on producers polluting the environment, enforcing them to bear the external costs of their activities (production). Another example of regulative taxes is excise duties charged on cigarettes or alcohol. Such taxes increase the price of these harmful products and thus discourage their consumption directly. They are also called corrective taxes.

Last but not least, the objective of imposing taxes is to implement the **government's macroeconomic policy**. Taxes are used as a stabiliser to the economic growth. Increasing or decreasing taxes can affect entrepreneurs' economic activity and thus impact unemployment, investment, inflation, etc.

Desirable features of a tax system

The quality of the tax system is essential. The tax system not only brings revenues necessary for the public sector to function but also affects the behaviour of the taxpayers and, thus, the economy as a whole. Adam Smith laid down the principles of an effective tax system in his "Wealth of Nations" (1776). Referred to as "Canons of taxation", these principles have not changed much since their introduction.

1. Equity

The first principle, followed by most tax policymakers, is equity. The tax system should be fair to all individuals. Taxes should be levied based on the ability to pay taxes, i.e., on the taxable capacity. Taxes are classified as proportional, progressive, or regressive according to the tax burden placed on the taxpayer. If the amount of tax to be paid increases directly in line with increases in the tax base, the tax is proportional. If the tax increases faster than the increase in the tax base, the tax is progressive. If the tax increases relatively less than the tax base, the tax is regressive. Opinions on equitable distribution of the tax burden widely vary. A state's tax policy, in turn, decides what taxes are implemented in terms of their progressivity.

2. Certainty

The second desirable characteristic of the tax system is legal **certainty,** which grants the taxpayer knowledge of when and where their tax liability needs to be settled. Tax laws should not be ambiguous and constantly changing. Taxes must not be altered retrospectively. A different perspective on this subject concerns the **tax incidence.** Ideally, it should be clear who effectively bears the tax burden. A person paying taxes to the financial authority can potentially forward the tax costs to their customers by increasing the charged prices. Alternatively, tax can also be shifted backward to the employees by reducing their wages or to subcontractors, etc. The corporation (corporate) taxes are often accused of being shifted away from companies.

3. Convenience

The third principle required by the tax theory and policy is convenience. The tax should be imposed in such a manner that the taxpayer can easily pay it. The typical example is tax withheld at source (e.g., tax on savings interests). Another good example is VAT collected by the supplier from their customer[1] and paid to the financial authorities. On the other hand, the individual income tax is paid only once a year. At that time, the taxpayer might have expensed a major part of their annual earnings, which is certainly not convenient.

4. Effectiveness

The fourth principle, effectiveness, is very important and sometimes contradicts the equity principle. An effective tax system should not affect the market allocation of resources and, at the same time, should be cheap to administer. **Economic effectiveness** means that imposed taxes do not distort the commercial decisions of the individuals. A good example of a distortive tax is the individual income tax levied at a high rate. Such a tax can discourage people from working. Another type of effectiveness is expressed by **administrative costs** of the tax system incurred by the financial authorities and compliance costs to the taxpayers.

Adam Smith did not mention other desirable characteristics, but these were added later on as the tax system became more complex. These are **simplicity** and **flexibility**. The system should be simple so taxpayers can understand and comply with its rules. Tax administrators should be able to collect taxes based on clear rules and enforce compliance without numerous disputes with taxpayers. Flexibility means that the system should develop together with economic relationships and business structures.

Taxes in the Czech Republic

The tax system of the Czech Republic was established in 1993. Since their first implementation, the tax legislation contains several frequently amended laws. The value-added tax and excise duties were substantially modified in 2004 upon the Czech Republic’s EU accession. Transfer taxes, such as the gift and inheritance taxes, were abolished at the end of 2013. Recently cancelled also got the real estate transfer tax. The following table provides an overview of the Czech taxes and the relevant legislation valid as of 1 January 2023.

[1] The supplier charges the customer the price plus the appropriate VAT which he pays to the state budget, usually on monthly basis.

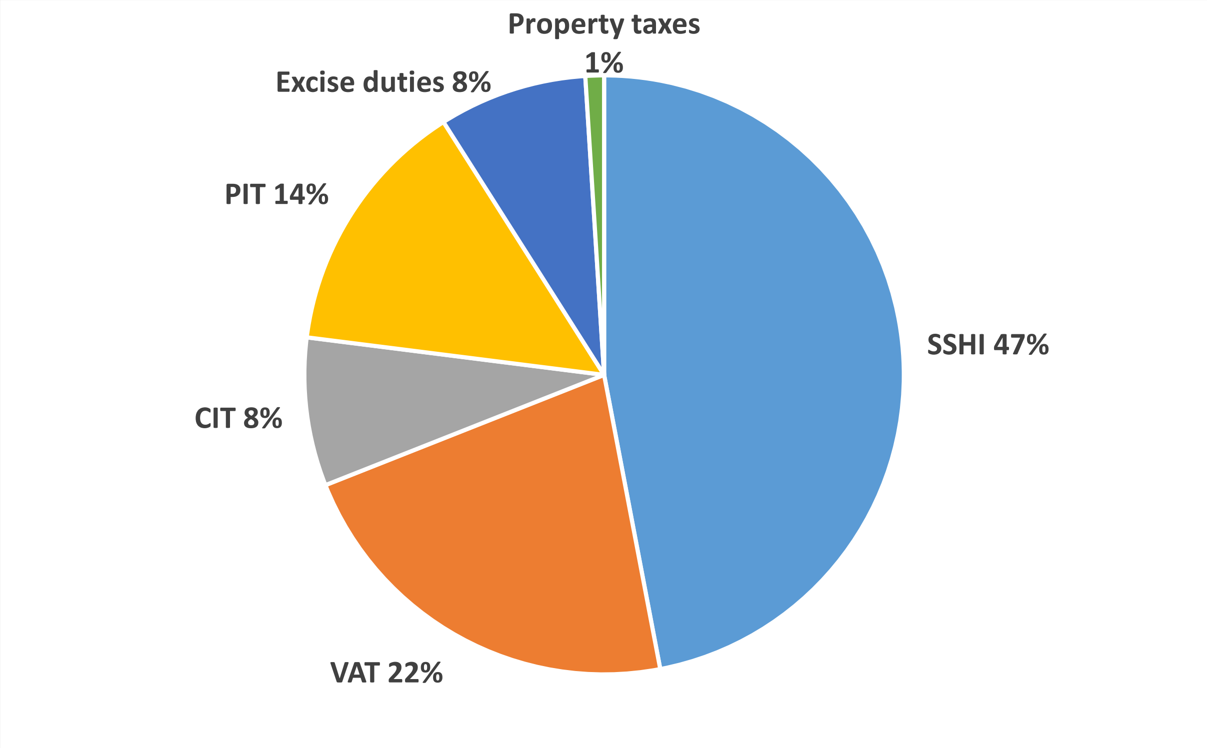
Table 1: Overview of the Czech taxes

Personal Income Tax	Act No. 586/1992 Coll. on Income Taxes
Corporate Income tax	Act No. 586/1992 Coll. on Income Taxes
Social Security Contributions	Act No. 589/1992 Coll., on Contributions on Social Security and the Unemployment Policy Act No. 187/2006 Coll., on Sickness Contributions
Health Insurance Contributions	Act No. 592/1992 Coll., on Health Care Contributions
Value Added Tax	Act No. 235/2004 Coll. on Value Added Tax
Excise Duties	Act No. 353/2003 Coll. on Excise Duties
Environmental Taxes	Act No. 261/2007 Sb., on Stabilisation of Public Budgets, parts related to taxation of electricity, natural gas and solid fuels
Road Tax	Act No. 16/1993 Coll., on Road Tax
Real Estate Tax	Act No. 338/1992 Coll., on Real Estate Tax

Taxes are collected by the tax authorities according to Act No. 280/2009 Coll., on Tax Administration.

The major income of the public budgets' revenues is **social contributions** – about 40% of their total revenues. **VAT** represents the second most significant revenue source – around 23% of total revenues. An overview of the structure of the Czech tax system is shown in Figure 1 below. Minor taxes such as the road and real estate taxes contribute less than 1% of total revenues.

Figure 1: Czech Tax system structure – share of revenues in % (2020)



Summary

To summarise the chapter, taxes are levied to finance the state's public activities. Their other function, among numerous others, is to regulate the activities of citizens. Taxes can be imposed on various tax bases. They differ in their impact on individuals and the economy as a whole. A desirable tax system[2] should be fair, effective, simple, and predictable to the taxpayers.

Discussion questions:

1. Do you consider the tax system of your country simple to comply with?
2. How would you improve the tax system in your country?

[2] More about the tax theory can be found in Lymer, Oats (2014).

2. Corporate Income Tax[3]

This chapter provides basic terms related to the corporate income tax in the Czech Republic as well as basic principles of its calculation and payment.

Basic terms

Corporate income tax is a universal income tax paid by all corporations; corporations are *taxpayers*.

Its taxpayers are considered to be the Czech *tax residents* if their seat or place of management is in the Czech Republic or the Czech *tax non-residents* if otherwise. Tax residency is related to international aspects of taxation. The Czech tax residents have a worldwide tax liability in the Czech Republic, while the Czech tax non-residents have their tax liability limited on their income from the sources in the Czech Republic.

A different approach is applied to *business corporations* (established to reach profit) and non-business corporations (established for purposes other than profit). Further on, we shall discuss only the case of business corporations.

The tax period for the corporate income tax is a calendar or financial year. In special situations, such as changes from the calendar to the financial year or mergers, the tax period can be longer or shorter than twelve months.

Calculation of tax (general)

Calculation of the corporate income tax is generally relatively simple and can be divided into four steps:

1. determination of the tax base,
2. specification of applicable tax deductions,
3. application of the corporate income tax rate,
4. specification of applicable tax credits.

However, the above steps require special attention as the rules can be quite complex.

[3] Sometimes also "Corporation tax".

Both tax deductions and tax credits are intended to support various kinds of desirable behaviour.

	Tax base
-	Tax deductions
	- Losses
	- Research and development expenditure
	- Support of professional education
=	Subtotal
	- Donations to qualifying public beneficial organisations
=	Tax base reduced by deductions (rounded down to CZK thousands)
X	Tax rate
=	Tax
-	Tax credits
=	Tax after tax credits (final tax liability)

Tax base

The tax base is assessed for the accounting period, and its determination starts with the difference between income and expenses as allocated for the financial statements (accounting profit/loss). As the starting point for the determination of the tax base, the profit/loss taken from the financial statements must be:

1) before taxation, and

2) without the impact of international accounting standards.

Since the accounting principles pursue other interests than corporate taxation, such an accounting profit/loss must be adjusted (increased/decreased) to follow the tax rules properly.

Adjustments must take place on the side of both income and expenses. Adjustments are mostly (but with exemptions) made on the income side via a *decrease* in the accounting economic result, while adjustments made on the side of expenses *increase* the accounting economic result.

Income

- Income not liable to tax

  Income not liable to tax must be deducted so that it does not influence the tax base; not liable to tax are specific types of income, such as income in the form of shares under special conditions of the transfer of assets from the state to other persons, or income of health insurance agencies under specific situations.

- Exempted income

  Special tax exemption rules apply to certain types of income, such as dividend income within the EU between the related parties or income from inheritance and received gifts under special conditions. Such income must be deducted so as not to influence the tax base.

- Income taxed under the separate tax base

  A special separate tax base is used for certain types of income, such as dividend income which is not exempt. Such income is taxed separately and thus should not influence the tax base.

Expenses

- Non-tax-deductible expenses

  In general, only expenses incurred in order to generate, assure, and maintain the (taxable) income can be deducted for tax purposes.

  Furthermore, the tax legislation (Income Tax Act) provides special rules or limits for certain types of expenses.

  For tax purposes, expenses that cannot be considered are called non-tax-deductible expenses. Accounting profit/loss must be increased by tax non-deductible expenses so that it does not influence the tax base.

- Depreciation

  Accounting depreciation often differs from tax depreciation. The difference between the tax and accounting depreciation increases or decreases expenses. If the accounting depreciation is higher than the tax depreciation, expenses must be lowered and vice versa.

Income/Expenses

- Reserves and provisions

  Reserves are tax deductible only if created according to the special legislation (Reserve Act). Impacted could either be the side of expenses (creating) or income (dissolving).

- Receivables and liabilities

  Contractual receivables and obligations are included in the tax base only when paid. Special rules apply to the provisions to receivables that could be included in the tax-deductible expenses. Those must be created according to the special legislation (Reserve Act).

  Obligations to the state, such as penalties owed to the tax authority, are always considered tax non-deductible.

Tax deductions

Tax losses

Taxpayers are entitled to a loss relief for business losses; the tax loss can be set against the tax base as "carry forward" at a maximum for five consecutive tax years, while the loss "carry back" for two years is available.

Research and development expenditure

Tax deduction of research and development expenditures was introduced in 2005 to support research and development carried out by business entities. Taxpayers can deduct 100% of expenses incurred within R&D. To motivate taxpayers further to accelerate their investments into research and development, the difference between expenses on research and development in the current year and the year preceding it can be deducted in the amount of 110%.

Support of professional education

Tax deduction on professional education consists of two parts. First, deduction on the acquisition of property; second, deduction of the expenditure on students in professional education.

Donations to the qualifying public beneficial organisations

Donations to qualifying public organisations and for set purposes can be deducted within certain limits. Qualified purposes include science and education, research and development, culture, schools, youth welfare, animal protection and charities, social purposes, health care purposes, etc.

There are both the minimum (CZK 2,000 value of one donation) and maximum (10% of the tax base after-tax losses and research and development) limits for deducting donations.

Tax rate

Since 2010, the corporate income tax rate has been linear in the amount of 19%. Over the past decade, it has been the practice in developed countries to lower the corporate income tax rate, and the Czech Republic is no exception. For comparison, the 2003 corporate income tax rate in the Czech Republic was 31%.

The tax rate of 15% applies to special types of income taxed within the separate tax base, and the tax rate of 5% applies to investment funds.

Tax credits

Final tax liability can be reduced by tax credits that are based on the number of disabled employees (more precisely, the number of hours worked by the disabled person). The tax credit amounts to CZK 18,000 per disabled person and to CZK 60,000 per severely disabled person.

Payments

Corporate income tax is payable annually based on the chosen tax period (calendar or economic year), with the basic term of three months following the end of the tax period. However, for companies with a mandatory audit or those with the tax return filed by the certified tax advisor, it is six months after the end of the tax period.

Based on the final tax liability, the tax prepayments are calculated.

Summary

Corporate income tax is paid on taxable profits of companies. Basic tax components, such as tax deductions, linear tax rate, and tax credits, are used to calculate corporate income tax. Over the past decade, modern economies have lowered the corporate income tax rate mainly due to tax competition.

Questions

1. What are the trends in the corporate income tax rate in the EU?
2. What is the purpose of tax deductions? Would you abolish tax deductions or increase their role (e.g., create new deductions)?

3. Personal Income Tax

This chapter provides basic terms related to the personal income tax in the Czech Republic, along with the basic principles of its calculation and payment.

Basic terms

Taxpayers of the personal income tax are natural persons (individuals). Taxpayers are Czech tax residents if their presence in the Czech Republic during the calendar year is longer than 183 days or if they have a permanent home in the Czech Republic. Those who are not Czech tax residents are considered Czech tax non-residents. However, the double tax treaties must be considered when assessing the given individual's tax residency.

The tax period for the personal income tax is the calendar year.

Calculation of tax

The personal income tax calculation is slightly more complicated than the calculation of the corporate income tax. Even here, we may follow several basic steps:

5. classification of income according to the relevant partial tax bases,
6. determination of the partial tax bases,
7. calculation of the total tax base,
8. specification of applicable tax deductions,
9. application of the personal income tax rate,
10. specification of applicable tax credits.

However, the above steps require special attention as the associated rules can be quite complex.

Tax base

The tax base is divided into five partial tax bases, mainly due to the possibility of treating expenses separately for different types of income.

The calculation of the personal income tax includes the partial tax base on:

- income from dependent activity (employment),
- income from independent activity (self-employment),
- capital income,
- rental income,
- other income.

An essential part of calculating the personal income tax is an application of expenses, in particular partial tax bases. Taxpayers can deduct expenses within the given partial tax base from independent activity, rental income, and other income.

Expenses are recognised as either

1) real (actual) expenses; expenses that were realized and are documented by the taxpayer, or
2) lump-sum expenses; expenses are calculated as a percentage of the taxable income.

In the Czech Republic, lump-sum expenses are especially important for the self-employed as the lump-sum expenses allowed by the Czech tax legislation are generous compared to other countries.

Income from dependent activity

The partial tax base from dependent activity includes mainly income from employment, remuneration of executive directors, income for work of associates of limited liability companies, remunerations of the members of statutory bodies, etc.

Until recently, the partial tax base from dependent activity was calculated as gross income **plus** contributions to the social security and health insurance paid mandatorily by the employer. This concept was introduced in 2008 as the so-called "super-gross salary". At the same time, the tax rate has been changed from progressive (12% – 32%) to linear (15%).

Since 2021, the tax base from dependent activity is calculated as gross income. Accordingly, the rate went back from flat tax to progressive (15% and 23%).

Deducting any expenses when calculating the partial tax base on income from dependent activity is impossible.

Income from independent activity

The partial tax base from independent activity includes mainly income from trade and other business activity regulated by the law, income from agriculture and forestry, income from other independent professions (such as sportsmen and artists), etc.

Taxpayers can decide between the real (actual) and lump-sum expenses.

Type of Income	Rate (%)	Maximum Limit (CZK)
Agricultural business	80	1,600,000
Craft business	80	1,600,000
Other business	60	1,200,000
Independent professions	40	800,000
Rentals	30	600,000

Lump-sum expenses are allowed by the law in the amount of 30, 40, 60, and 80%, according to the type of income. There is a cap on lump-sum expenses.

The partial tax base from independent activity is calculated as income **minus** expenses.

Capital income

The partial tax base from capital income includes mainly dividends, income from participation in limited liability companies, interests on savings, etc.

Deducting any expenses when calculating the partial tax base from capital income is impossible.

Taxation at source by withholding tax is often used for capital income tax. Withholding tax is considered to be final. Income taxed by withholding tax is not included in the partial tax base with the exemption of income from abroad, where the credit method for avoiding double taxation applies.

Rental income

The partial tax base from rental income includes mainly income from leasing real estate, flats and movables (if not considered occasional).

Taxpayers can decide between the real (actual) expenses and lump-sum expenses.

Lump-sum expenses are allowed by the law in the amount of 30% of the rental income with the absolute limit (cap).

The partial tax base from rental income is calculated as income **minus** expenses.

Other income

Income not included in the previous partial tax bases is taxed as other income, mainly occasional income, sales of assets, winnings, etc.

Taxpayers can deduct expenses related to a particular income. The amount of income limits expenses; no loss may occur.

The partial tax base from other income is calculated as income **minus** expenses with no possibility to create tax loss.

Total tax base	**Income**	**Expenses**	**Partial tax base**	**Separate tax base**
Income from dependent activity	Gross income from employment, remuneration of executive director, etc.	-	Gross income	Yes Income from special contract used for part-time job in the maximum amount of CZK 10,000 per month
Income from independent activity	Income from independent activity	Real or lump-sum expenses (30% – 80%, with caps)	Income minus expenses	Yes Income of authors in the maximum amount of CZK 10,000 per month
Capital income	Gross capital income	-	Gross capital income	Yes
Rental income	Rental income	Real or lump-sum expenses (30%, with caps)	Income minus expenses	No

Other income	Gross income	Real (in the amount of the income at maximum)	Income minus expenses	No (only minor)

Total tax base

The tax base is the sum of partial tax bases; however, special rules apply to deducting partial tax losses. Tax loss can generally be established only within the partial tax base from income from independent activity and rental income. No further deductions, such as established tax loss, can be subtracted from the partial tax base on income from dependent activity. As a result, the total tax base can never be lower than the partial tax base on income from dependent activity.

Tax deductions

Taxpayers are allowed to use different tax deductions to lower their tax base.

Tax loss

Taxpayers are entitled to a loss relief; tax loss can be set against the tax base as "carry it forward" for the maximum of five consecutive tax years or "carry it back" for two years.

Research and development expenditure

Although taking advantage of the research and development tax relief for corporations is more usual, it can also be deducted by a natural person if all the conditions stipulated by the tax law are met. Conditions and limits are the same as for corporations (corporate income tax).

Support of professional education

Tax deductions on professional education consist of two parts. First, there is the deduction on property acquisition; second, there is the deduction of expenditure on students in professional education.

Donations to qualifying public beneficial organisations

Donations to qualifying public organisations and for set purposes can be deducted to certain limits. Qualified purposes are, e.g., science and education, research and development, culture, schools, youth welfare, animal protection and charities, social purposes, or health care purposes.

There is both the minimum (CZK 1,000 or 2% of the tax base) and maximum (15% of the tax base) limit for deducting donations.

Mortgage interest

Taxpayers can deduct interest paid on mortgages and loans used for their housing needs in the maximum amount of CZK 150,000 (limited to one family).

Pension insurance contributions

Taxpayers can deduct their contributions paid to state-contributory pension funds and supplementary pension savings based on the law on supplementary pension savings. The amount that can be deducted must exceed CZK 12,000. Maximum tax relief of pension insurance contributions is CZK 24,000 per year. That means that to use the maximum tax relief, a taxpayer must contribute the amount of CZK 36,000.

Life insurance contributions

Taxpayers can deduct their contributions paid for life insurance, provided special conditions given by tax law are met. The maximum tax relief of life insurance contributions is CZK 24,000 per year.

Trade union contributions

Taxpayers can deduct their trade union membership contributions worth up to 1.5% of their taxable income from the dependent activity with the maximum limit of CZK 3,000.

Payments for re-certification exams

Taxpayers can deduct their payments for re-certification exams in the maximum amount of CZK 10,000, CZK 13,000 (for the disabled), and CZK 15,000 (for the severely disabled).

Tax rate

The personal income tax rate is progressive in the amount of 15% and 23%. The upper rate applies to income exceeding 48 times the average wage.

Tax credits

Taxpayers can make use of various tax credits. To give an idea, we also provide the amounts applicable for 2023. However, there is no need to remember those figures for your exam.

Personal tax credit

All taxpayers (with the exemption of those who received old-age pensions at the beginning of the tax period) are entitled to the personal tax credit in the amount of CZK 30,840.

Spouse tax credit

Taxpayers can claim the tax credit in the amount of CZK 24,840 if their spouse's income does not exceed CZK 68,000 during the tax period.

Disability tax credit

Disabled taxpayers can claim the tax credit in the amount of CZK 2,520, CZK 5,040, or CZK 16,140 based on the degree of disability.

Student tax credit

Taxpayers qualifying as students can use the tax credit in the amount of CZK 4,020.

Pre-school tax credit

Payments to preschool institutions for children visiting the institution can be deducted as a tax credit. The maximum limit that can be deducted is the minimum salary amount.

Tax relief (tax credit/tax bonus) on a dependent child living with the taxpayer

Taxpayers who live with a dependent child can use tax relief. The tax relief differs for the first (CZK 15,204), second (CZK 22,320), and further (CZK 27,840) children. This tax relief can be a tax credit (lowering final tax liability) or a tax bonus (creating negative tax).

Disabled employees

Taxpayers with disabled employees can use the CZK 18,000 tax credit per disabled person and CZK 60,000 per severely disabled person.

Payments

Personal income tax is payable annually, generally with a deadline of three months after the end of the tax period. However, if a certified tax advisor files the tax return, the deadline gets extended to six months following the end of the tax period.

The tax authority also prefers digitally filed tax returns; therefore, the deadline is extended to four months if the forms are filed electronically.

The employer pays prepayments from dependent income (employment) as payroll tax, usually monthly.

Other prepayments are paid based on the final tax liability, either quarterly or semi-annually.

Discussion Questions

1. What are the reasons for splitting income into partial tax bases?
2. When is the withholding tax used and why?
3. What is the experience of countries with a flat tax rate?

4. Social Security Insurance (and Health Insurance)[4]

This chapter provides basic terms related to social security insurance (and health insurance) in the Czech Republic and its calculation and payment principles.

Basic terms

Social security systems vary significantly among the individual countries. This variety of social security systems can confuse even within the basic terms; therefore, we must be cautious when using the basic terminology in social security insurance.

Suppose we follow the terminology adopted by the national legislation. In that case, we will use the term "social insurance" as superior to the terms "social security" and "public health insurance" (further also "health insurance"). Social security insurance in the Czech Republic includes pension, sickness, and state employment policy contributions.

Public health insurance covers health care. Pension insurance covers mainly old-age pensions, disability pensions, etc. Sickness insurance covers the risks of being unable to work due to sickness; however, an important part of sickness insurance is maternity leave.

As we shall find out over the following chapters, on an international level, the term social security usually includes all the related systems, with no exemption for health insurance. Even though this chapter will focus on the social security system in the Czech Republic, we will try to follow international conventions without being incorrect from the Czech perspective. That is why we shall refer to the terms "pension and sickness insurance"[5] and "health insurance". This way, we do not have to use the term "social security" and confuse readers who do not have a broader knowledge of the Czech system.

Payments paid to the relevant authorities are referred to as contributions. Contributions can be obligatory and voluntary (for pension and sickness insurance).

[4] The parentheses will be explained further in the text.
[5] For our purposes this also includes the state employment policy contribution.

Participants

In general, four subjects are relevant to social security:

- ***employees*** are insured because of their employment and contribute to the system with a part of their salaries,
- ***employers*** withdraw the contribution paid by employees and contribute to the system on behalf of their employees,
- ***self-employed*** are insured because of their business activity and
- ***others*** are individuals without income (from employment or business) who participate in health insurance if they have a permanent residence in the Czech Republic.

There are exemptions from participation in social security, e.g., part-time or low-wage employment relationships. The different regime applies for the self-employed according to their activity, as it could be the so-called "main" or "secondary".

Contributions are payable from the employment and business income or as a lump sum (for individuals without employment and business income regarding health insurance).

Calculation of contribution to social security (and health insurance)

The calculation of contributions towards the pension, sickness, and health insurance differs for employment relations and the self-employed; however, it closely relates to the personal income tax. The basic steps for the calculation of contributions are as follows:

1. determination of the participation in pension, sickness, and health insurance (employment, self-employment, other),
2. determination of the assessment base (based on the partial tax bases of the personal income tax base),
3. application of the minimum and maximum limits,
4. calculation of contributions.

Assessment base and rates

The assessment base of employees and self-employed is closely linked to the partial tax bases of the personal income tax.

Employment

In general, the assessment base of employees with an employment relationship under the Czech labour law is the sum of all income from employment and employment-related benefits that:

- is taxable by personal income tax according to the Act on Income Taxes,
- is not exempted from this tax,
- the employer accounts for the employment.

Some forms of income, such as compensations for damages as defined by the Labour Code or severance pay, are not included in the assessment base.

A minimum assessment base (minimum wage) is being specified for health insurance purposes. A maximum assessment base (48 times the average wage) is being specified for pension and sickness insurance.

The contribution rate for health insurance is 13.5%, one-third of which the employer deducts from the employee's wages, and the remaining two-thirds pays the employer.

The contribution rate for pension and sickness insurance is 6.5% for the employee and 24.8% for the employer. The employee's payment goes entirely towards pension insurance, while the employer's share is split into 2.1% for sickness insurance, 21.5% for pension insurance, and 1.2% for the state employment policy contribution.

The contribution is paid as frequently as the employer accounts for the relevant income, presumably once a month.

Self-employment

Self-employed individuals pay contributions based on their personal income tax liability from the business activity.

The assessment base is 50% of the taxable income minus expenses from the business activity. Both the minimum and maximum limits must be respected.

The contribution rate is 13.5% for health insurance and 29.2% for pension insurance, 1.2% of which goes to the state employment policy.

Participation in sickness insurance of the self-employed is voluntary.

Other

Individuals without employment or business can still participate in social security either obligatorily (for health insurance, if they have a permanent residence in the Czech Republic) or voluntarily (for pension insurance if they want to secure their pension benefits in the future).

Discussion Questions

1. Why is social security paid only on income from employment or business activity?
2. Discuss the differences in contributions on pension, sickness, and health insurance of employees and the self-employed concerning the personal income tax base.

5. International Income Taxation and Tax Planning

This chapter provides basic information about international income taxation, aiming to introduce the basic concepts and terms within this topic.

Globalisation means that national tax policies are no longer isolated. Governments must consider tax competition when maintaining their tax systems and approach greater cooperation with other countries to enable international trade.

The basis of international taxation provides international law, mainly using the worldwide network of bilateral double taxation treaties. The Vienna Convention on the Law of treaties and the Treaty of Rome are important for more general interpretation.

The essential question in international taxation is: **Which individuals and companies may be taxed by the given country, and to what extent?**

To answer this question, the principles of *tax residency* and *source* are adopted. Countries usually want to tax worldwide income and gains of their residents and all the income and gains arising within their jurisdictions. Double taxation occurs if all the countries apply such a policy – to tax a resident of one country with the income arising in another country. Hence, the two countries in question should agree on which of them has the right to tax international income flows.

Double tax problem

Double taxation means the taxpayer is exposed to tax more than once on the same income. There are two types of double taxation – economic and juridical.

Economic double taxation includes any situation where income is taxed twice. An example can be the commonly adopted taxation of corporate profits (the corporate income tax first taxes any profit, and possible dividends are subsequently taxed by the personal income tax).

Juridical double taxation is a concept narrower than economic double taxation and covers situations when more than one country attempts to tax the same income. Juridical double taxation is, therefore, of interest for further discussion.

Double tax treaties

To overcome the double taxation problem, countries conclude bilateral double-tax treaties. Concerning the two main principles mentioned above – the principle of tax residency and the principle of source – these treaties can be applied differently within the national tax legislation of any two countries, as their tax systems possibly differ. Double tax treaties, therefore, comprise a set of rules with the aim to:

- avoid double taxation,
- prevent tax evasions,
- prevent discrimination between taxpayers,
- provide legal certainty in international operations.

In general, treaties' provisions override the provisions of domestic tax law. However, tax treaties can never make a taxpayer worse off than under domestic law.

The OECD model tax convention

In 1963, the OECD drafted the Model Tax Convention on Income and Capital (thereinafter "Model Treaty" or "Treaty"); although not binding, it is nevertheless commonly adopted as a template for bilateral treaties. Detailed Commentary on the Model Treaty is widely used to interpret particular treaties.

The Model Treaty consists of 31 Articles that are organised into seven Chapters.

First, the Treaty specifies the personal scope and taxes that are covered in each contractual state. Furthermore, it states the definitions needed for the application of the Treaty; particular care is given to the definition of the (tax) resident and its permanent establishment. Articles 6 to 22 deal with the particular types of income (such as income from immovable property, business profits, dividends, interest, royalties, capital gains, income from employment, director's fees, pensions, etc.) and constitute the right of the states to tax it. Article 23 specifies the methods for the elimination of double taxation. Special provisions cover non-discrimination issues, mutual agreement procedures, exchange of information and assistance in collecting taxes. Final provisions are needed to specify the treaty's entry into force and termination.

Double tax relief

To avoid (reduce) the phenomenon of double taxation, three main methods are commonly used:

- The exemption method. The country of residence exempts the foreign income and does not tax it.

- The credit method. The foreign income is included in the tax base at the country of residence; however, the country of residence allows the deduction of any tax charged by the source country.
- The deduction method; the foreign income is included into the tax base while the tax paid on foreign income is treated as a tax deductible business expense.

Further variations of these methods exist, such as full exemption and exemption with progression and full and ordinary credit.

Principle of tax residency and source income

As stated above, tax residency and source country are the main concepts in international income taxation. Therefore, let us discover more about their respective meaning.

While the tax residents tax (declare) their worldwide income in the country of residency, the tax non-residents tax their income from the source in this non-resident country.

All the international double tax treaties contain a definition of the tax resident, while the national tax legislations contain their own definitions. If both countries, according to their respective national legislations, consider an individual or a company to be their resident, the double tax treaty determines the tax residency.

Its seat and management place usually determine a company's tax residency.

An individual's tax residency is according to the Model Treaty determined by the set of criteria listed below. The order of the criteria is highly relevant; if one cannot decide according to the first criterion, the second criterion is used, and so forth:

- permanent home,
- centre of vital interest,
- habitual abode,
- citizenship,
- agreement of contractual states.

Source income (or income from source) is the income that the country taxes, even though the owner (receiver) of the income is its tax non-resident. The term "source" might give the wrong impression that it depends on where the income is sent from. It might differ with the type of income. Still, in general, the income from the source is determined by the country's geography, meaning that, e.g., the work for which the income is being paid has been performed on the territory of the given country or the service was provided at this country, etc.

International Tax Planning

This chapter examines international tax planning, cross-border transactions, and tax competition.

In the previous chapter, we learnt about double tax treaties as the set of international rules agreed upon among the countries concerning the allocation of the given tax and the cooperation in tax matters. We have also learnt that international treaties are not harmonised the tax systems entirely; the individual tax systems stay unique and within the power of each government. Differences within the tax systems, globalisation, and freedom of movement of persons and services create the grounds for tax planning and competition. Tax planning is on the side of taxpayers who want to pay less taxes, and tax competition is on the side of governments who want to attract investors as potential taxpayers.

Tax planning

Tax planning, in its broadest meaning, represents the analysis of possible tax scenarios for the given situation so that the most efficient tax position can be chosen. Tax planning may consider tax expenses, reward system of employees, tax depreciation, carry forward of tax losses, etc. Tax planning encompasses all the taxes, meaning that tax planning is used for income tax, value-added tax, and other taxes.

We can also come across the term “aggressive tax planning”. Aggressive tax planning has the same purpose – to choose the most efficient tax position – however, for this purpose, unintended loopholes and mismatches in legislation or the tax process are considered. Aggressive tax planning can often be classified as an abuse of the law and thus regarded as illegal. This term – aggressive tax planning - is mainly linked with the corporate income tax.

International tax planning most often means tax planning of cross-border transactions, when taxpayers can take advantage of the differences between individual tax systems to minimise their worldwide tax liabilities.

Tax competition

Tax competition occurs when governments lower their tax rates, give tax incentives, or lower the overall tax burden to attract investors, improve labour markets, and increase productivity.

In exchange for a certain decrease in the tax rates (or the tax level), the governments believe in boosting their tax revenues.

However, not only the amount of tax paid is important within the tax competition. Tax legitimacy, e.g., application and interpretation of the tax law, the process of tax collection, etc., must also be considered.

In connection with the tax planning and tax competition, discussions on tax havens become increasingly relevant over the last quarter of the twentieth century. Tax havens are generally countries that apply aggressive tax competition. The purpose is to attract business and mobile capital. For this purpose, they create highly competitive tax systems compared to other countries or charge hardly any tax. Tax havens are also called "offshore financial centres". International organisations, mainly the OECD, have taken quite a strong anti-tax haven policy view as it is believed that tax havens create harmful tax competition on the global markets.

Tax avoidance and evasion

There are vivid discussions about the difference between tax planning, tax avoidance, and tax evasion, as there is no firm line to distinguish between these terms.

Tax avoidance and tax evasion have quite a different substance than tax planning, which can be considered a part of rational business analysis. Tax avoidance usually means applying the tax law literally but failing to respect its purposes (intentions); tax avoidance can be considered aggressive tax planning. In certain situations, tax avoidance can be regarded as legal; however, as stated above, abuse of the law can apply.

On the other hand, tax evasion refers to situations that do not comply with the tax legislation and requirements of the tax system. Tax evasion is considered illegal.

Base Erosion and Profit Shifting (BEPS)

As the fairness of tax systems is believed to get undermined by some practices of international corporations that are moving their capital and activities to countries with low or hardly any taxation, the OECD has started a project known as BEPS (Base Erosion and Profit Shifting) to carefully analyse the rules that allow (or *if* they allow) the shifting of profits from countries where the business is actually carried out.

In July 2013, the OECD introduced the Action Plan on Base Erosion and Profit Shifting, which identifies specific actions (steps) that need to be considered by the governments to suppress undesirable tax planning. The plan addresses the need for closer international co-operation, greater transparency and efficient data and reporting requirements.

A multilateral instrument should amend the current bilateral tax treaties to ensure a quick implementation of the agreed steps.

In this context, further actions have occurred, such as the Anti-Tax Avoidance Directive (ATAD) for the EU countries or so-called Pillar 1 and Pillar 2 (Global minimal effective tax rate) adopted by the BEPS Inclusive framework.

Questions:

1. How many double-tax treaties have been concluded by your country? Do you think that it is sufficient, or would you suggest other countries with which the treaty should also be concluded?
2. Why do the OECD and the EU take strong actions to suppress tax planning, even though it is considered legal?

6. Social Security Co-ordination in the European Union

This chapter aims to provide basic information on the principles of social security coordination in the European Union.

Role of social security systems and its co-ordination

The income of individuals is subject to several compulsory payments. In addition to the personal income tax, income from work is also subject to payments of the compulsory insurance contribution, which can be even higher than the personal income tax. More importantly, the social security system provides benefits to those who are in need (ideally).

Social security systems significantly vary across the European countries. At the same time, their coordination is crucial for compliance with the basic freedoms guaranteed by the European Union, mainly the **freedom of movement** of persons and services. The absence of coordination of contributions or benefits would cause a significant barrier to migration.

Just imagine that you decide to work for 15 years in Bilbao (Spain), 15 years in Lyon (France), and the rest of your working life in Göteborg (Sweden). Without the coordination of social security, your pension claims would be at risk (in fact, they would be non-existent), even though you contribute to the social security systems for your whole working life. But you would not be able to fulfil the basic criterion to receive the old-age pension, which is the number of years working in the country (here, meaning Spain, France, and Sweden).

Or imagine that after losing your job in Ostrava (Czech Republic), you become highly optimistic and search for a new adventure ("new dream job") in Reykjavík (Iceland). But without a coordination of social security, you would lose all your rights to unemployment benefits, as it would not be exported to you to Iceland.

We would find other examples to show how/why the coordination of social security is crucial for cooperation between the countries and even more for a union with a high level of integration, such as the EU. You can try it for yourself.

International coordination of social security is practiced mainly through the **EU Regulations on social security** (from now on, "EU Regulations"). Some countries where the EU Regulations do not apply conclude **bilateral agreements** on social security.

The bilateral agreements on social security are rather specific and have their own rules.

Since the EU Regulations on social security cover many countries, we will further specify the scope and principles stated in these regulations.

Scope of social security co-ordination within Europe

To understand the coordination of social security, we must assess its territorial, personal and material scope properly.

With the increasing number of EU member states, **the territorial scope** of social security coordination has gradually expanded. However, the EU Regulations do not cover only the territory of the EU (currently 27 countries) but also Norway, Liechtenstein, Iceland, and Switzerland.

The personal scope of social security coordination, as regulated by the EU Regulations, has undergone significant changes. However, we will focus on the current state of the personal scope, which emphasises and promotes the free movement of all citizens of the member states (states applying the EU Regulations) regardless of their reasons for migration. In other words, the EU Regulations on social security apply to citizens of the member states, stateless persons, and refugees living within a member state who are (or were) subject to the laws of one or more of the member states, plus their family members (even following their death).

The material scope of coordination is rather broad and covers almost all the branches of social security.

The material scope of co-ordination covers:

- sickness benefits
- maternity and equal paternity benefits
- invalidity benefits
- old-age benefits
- survivors’ benefits
- benefits in respect of accidents at work and occupational diseases
- death grants
- unemployment benefits
- pre-retirement benefits
- family benefits

Principles of the EU co-ordination

Coordination of social security must ensure that each migrant (within the scope of coordination) will be covered by the social security system, will not pay social security more than once, and will preserve their rights to social security benefits.

These needs are mirrored in the **basic principles of the EU co-ordination**:

- equal treatment
- single applicable legislation
- aggregation of the periods of insurance (preservation of the rights when acquired)
- exportability of benefits (preservation of the acquired rights)
- good cooperation and administration

The principle of **equal treatment** protects persons covered by the EU co-ordination regulations against direct and indirect discrimination.

Direct discrimination in social security coordination can be understood as a situation in which persons are judged based on some discriminating criteria – such as citizenship. This means that the citizens of one country are treated in social security differently than those of another state.

Indirect discrimination in social security coordination involves any discrimination based on other criteria that ultimately results in disadvantages for the citizens of other countries or a particular group of people, such as migrating workers. A typical example is the case of social benefits paid out only after the person has participated in the country's social security system for a certain period. A worker who moves around a lot and is covered by social security systems in several countries would thus never acquire the right to claim benefits.

A sub-category of equal treatment is the principle of equal assessment (assimilation) of facts or events. According to this principle, facts, income, and other circumstances that are related to the migrant's claims but that arose in other countries must be assessed in the same manner as facts, income, and circumstances arising in the relevant member state.

The principle of **single applicable legislation** serves to overcome conflicts between social security systems of different countries. Such conflicts in national legislation could lead to: 1. The situation when a person would be covered by no social security system (negative conflict), or 2. the situation when a person would be covered by more than one social security system (positive conflict). Both negative and positive conflicts must be avoided to secure the aim of social security coordination, which is why the set of rules for determining which legislation shall apply has been established within the EU coordination of social security. These rules determine one social security system that shall apply to the individual in question.

The principle of **aggregation of periods of insurance** ensures that the period of insurance gained by migrants in one member state (or countries covered by the EU coordination regulations) is included in the period necessary to claim the benefits in another state. If a worker travelling to another country for work does not meet the relevant country's time requirement for insurance, this period requirement would be met if it included the period of insurance from another member state. This condition is met, and the relevant country must consider the period of insurance in the other member states when assessing the worker's entitlement to benefits.

According to **the principle of exportability**, the competent institution must export benefits to another country covered by the EU coordination regulations. Once a person is granted a benefit, s/he does not lose this benefit if s/he moves to another country, even if s/he is not economically active in the other country.

The principle of good administration (co-operation and mutual assistance among the member states) emphasises effective cooperation and communication among the various countries' relevant institutions as the fundamental factor for good social security coordination. None of the above principles can be effective if not respected and applied in practice by the relevant national institutions.

Questions:

1. Find the basic rules for determining a single applicable legislation.
2. With how many countries does your country coordinate the social security systems?

7. The VAT System, Taxable Persons, and Their Registration

This chapter focuses on the basic principles of VAT and their application to the most common transactions. Furthermore, we will learn who is liable for VAT and when such a person must register for VAT. Before we start talking about VAT, it should be emphasised that this tax is harmonised within the EU. The Council Directive 112/2006/EC on the common system of value-added tax (hereinafter "VAT") has to be implemented in all the member states. Therefore, the VAT rules are similar in the whole EU.

VAT is levied on consumption. It is an indirect tax, i.e. not levied directly on the person on whom it ultimately falls. It is applied by producers and other suppliers (VAT payers) on the supplies of goods and services to their customers who pay the tax included in the price. It is assumed that the producers fully shift forward indirect taxes to their consumers by reflecting them in the sales prices. However, in the real world, this is not always the case. We can say that the indirect taxes differ from the direct taxes in such a way that for the indirect taxes, the shift forward to the consumer is at least possible and expected by the legislators.

VAT system

As mentioned above, final consumers bear the tax burden, but VAT payers collect VAT. Those are the producers, distributors and retailers that participate in a distribution chain through which the consumed goods and services are sold. The VAT payers must charge the output VAT on goods and services supplied ("output supplies"). They also have the right to claim the input VAT paid in the price of the goods and services purchased ("input supplies"). Their **tax liability** for each **taxable period** is the difference between the **output tax** and the **input tax**. This method of VAT collection is called a tax credit (or invoice method).

Based on the **tax credit method**, VAT can be easily imposed only on the value added by each producer. It should be noted that VAT does not represent a cost for the VAT payers because they book it as a transitory item in their accounting. They only collect the VAT from their customers and forward it to the treasury (financial authorities). This way, VAT collection ensures fiscal neutrality – an important principle in the application of VAT.

Fiscal neutrality means that the same goods or services are subject to the same amount of tax in relative terms. The amount of tax paid by the customer is equal to the product of the price exclusive tax and the applicable VAT rate. The significant feature of fiscal neutrality is the fact that the tax paid by the final consumer on identical goods is exactly the same regardless of the length of the distribution chain.

Example of tax credit method

	Sales	Tax on sales	Tax on purchases	To Treasury*
Forester	1,000	210	0	210
Pulp Factory	2,000	420	210	420 − 210 = 210
Paper Factory	3,000	630	420	630 − 420 = 210
Wholesaler	4,000	840	630	840 − 630 = 210
Retailer	5,000	1,050	840	1,050 − 840 = 210
VAT paid into the treasury				**1,050**

*Each taxpayer remits to the tax office the difference between his output and input tax (charged to him by his supplier)

The value added represents the producer's margin, which covers basically the wages, rents, royalties, and profit. An alternative method[6] of the calculation of VAT could determine the tax base for each taxpayer rather than for each taxable supply or the sum of taxable supplies per taxable period. In such a case, VAT would be applied to the sum of wages, rents, royalties, and profits ascertained from the annual books of the VAT payers. Although such "additive" methods would theoretically be possible, these would require an annual tax period and numerous adjustments[7]. As such, they are therefore rather complicated and not as convenient as the tax credit method. This is the reason why the tax credit method is so widespread and used practically in all the countries that have implemented the VAT.

The input VAT is recoverable by the taxpayers as long as they use the purchased goods or services (input supplies) for the purpose of their **economic activity**, more precisely for rendering their **taxable supplies** (output supplies). Some taxpayers perform not only taxable supplies but also **exempt supplies** without credit; such taxpayers are sometimes called partly

[6] More methods described in Terra, Kajus (2015).

[7] Profits normally reflect the depreciation allowance which should not be deducted if the value added is determined.

exempt persons. Exempt supplies without credit include, for example, financial and insurance services, postal services, health care, and many others.

Input VAT on purchased goods and services that the taxpayer uses for the production or rendering of exempt supplies without credit cannot be recovered. If a **partly exempt person** or a VAT non-payer participates in a supply chain, the fiscal neutrality principle is breached. The VAT incurred by the VAT non-payer or partly exempt person is not recovered, either fully or partially, depending on the status of the person. The amount of the non-recovered VAT becomes a cost for such a person and usually increases its prices.

An example of the tax credit method with a VAT non-payer present in the supply chain

	Sales	Output Tax on sales	Input Tax on purchases	To Treasury*
Forester	1,000	210	0	210
Pulp Factory (VAT non-payer)	2,210			
Paper Factory	3,210	674	0	674
Wholesaler	4,210	884	674	884 − 674 = 210
Retailer	5,210	1,094	884	1,094 − 884 = 210
VAT paid into the treasury				**1,304**

* Each taxpayer remits to the tax office the difference between his output and input tax (charged to him by his supplier)

The example above shows how fiscal neutrality gets breached if the VAT non-payer participates in the supply chain. The pulp factory cannot recover the VAT paid in the price of wood purchased from the forester. If we suppose that all the producers and distributors apply the same margin as in the previous example, the pulp factory and all the subsequent stages would sell their products for prices increased by 210. We can see that the non-recoverable VAT increases the costs of further stages of the chain in the amount of 210. Their sales prices are also higher as they maintain the required margin. The total VAT collected is higher than in the first example by the amount of 254 which includes the non-recoverable VAT from the first purchase of the pulp factory (210) and also the VAT applicable to the increase of the total price (210 x 0.21 = 44).

Various turnover taxes based on different ways of tax collection were used prior to the VAT implementation. The most common example could be the retail tax which is imposed in the last stage of the distribution chain when the products are sold to final customers. Such a system is still applied in the US and some other countries.

Other ways of collecting the turnover taxes are called cascade systems. They do not exist anymore. The tax used to be imposed at each stage of the production and distribution chain similarly to the VAT system, but there was no right to recover the input VAT. Therefore, the tax was cumulated in the price, which was the reason for using only very low rates in such systems.

Reverse charge

The VAT is sometimes collected in the opposite way than described above. The **reverse charge** system is used on the condition that both the supplier and the customer are VAT payers. It is applied to certain international movements of goods and provisions of services and also to local supplies of goods and services which are prone to the so-called carousel fraud[8] within the Czech Republic. These include e.g. waste, scrap, emission allowances, construction and assembly work, mobiles, microprocessors, tablets, laptops, game consoles, raw metals, grain, and crops.

When the reverse charge is applied, the supplier charges the price without the output VAT and the customer applies the output VAT on the purchased goods or services. Instead of paying the VAT chargeable on the purchased goods or services as a part of the price to the supplier, s/he declares this VAT as the output tax in her/his tax return. At the same time, such a customer can deduct this VAT as the input VAT as long as s/he uses the purchased goods or services for the purpose of rendering her/his output taxable supplies. The table below shows the collection of the VAT through the supply chain when the reverse charge mechanism is in place at some stages.

[8] Carousel fraud is a type of VAT evasion where the goods are cross-border purchased and the VAT on the subsequent local sale is not remitted in the chain.

Example of the reverse charge system

	Sales	Tax on sales – output tax	Output tax* on purchase of scrap (RCH)	Input tax on purchases	To Treasury** (output tax – input tax)
Producer of car components is selling scrap	1,000	0	0	0	0
Scrap reseller	2,000	0	210 (1 000 x 0,21)	210	210 − 210 = 0
Scrap processor selling metal sheets (subject to RCH) made from scrap	4, 000	0	420 (2 000 x 0,21)	420	420 − 420 = 0
Factory buying metal sheets and selling tools to final customers	5, 000	1,050	840	840	1,050 + 840 − 840 = 1 050
VAT paid into the treasury					**1,050**

*Tax paid by the customer on his/her purchase in the reverse charge mechanism.
** Each taxpayer remits to the treasury the difference between his/her output and input tax.

The first three VAT payers in the chain do not remit any VAT to the financial authorities as they use the reverse charge for their sales and purchases. However, the factory selling to final consumers does not apply the reverse charge on its sales. It calculates the total output VAT as the sum of the output VAT applied on the purchase of metal sheets (840) and the output VAT on the sale of metal tools to the final consumers (1,050). The factory remits to the financial authorities the tax liability of 1,050 (the difference between the total output tax and input tax). You can see from the table that fiscal neutrality is maintained even if the reverse-charge mechanism is used. The VAT paid in the final price by the customer is CZK 1,050 as he pays for the tools CZK 6,050 including VAT. This equals the VAT collected through the supply chain. At the same time, this amount corresponds to a 21% VAT rate applied to the final price.

Taxable persons

We have already mentioned VAT payers, but we should probably start with the term **taxable person,** in other words, a person liable to tax. Such a person is defined as an individual or legal person who independently carries out at any place an economic activity, whatever the purpose or the results of that activity. The **economic activity** also has its precise definition. It includes activities of producers, traders, and persons supplying services, including mining and agricultural activities, and activities of the professions and the exploitation of tangible and intangible property for the purpose of obtaining income therefrom on a continuing basis.

Activities of independent professionals such as authors, scientists, doctors, lawyers, auditors, etc. are also considered to be economic activities.

The category of legal persons includes, for example, business corporations, co-operatives, and public bodies. **Public bodies** are not always taxable persons. Public administration is excluded from the economic activity. Therefore, the status of the public bodies (e.g. municipalities) depends on whether they also perform some economic activity (e.g. sales of goods, advertisement services, rent from immovables, etc.).

The VAT legislation recognises also a specific taxable person called the **VAT group**. This group acts as one VAT payer and files a joint VAT return for the whole group. A group is created by related companies participating in their capital or voting rights by at least 40 % or having the same persons in their management (board of directors).

Characteristics of economic activity

The definition of economic activity rules out taxable persons as employees as they do not carry out their work **independently**.

The person should carry out the economic activity on a **continuous basis** to become a taxable person (e.g. an individual who sells a car, house, or other asset privately would not gain the status of a taxable person if this is not his/her regular activity).

The activity should also be performed for some **consideration**, i.e. some money should be charged for the goods or services supplied in order to qualify for the economic activity. If a charity organises an event free of charge or the entrance fee is voluntary, this would not be an economic activity. Therefore, the charity would not become a taxable person. However, if a charity sells products made for example by handicapped people for an affixed price, such sales will represent an economic activity.

On the other hand, it should be noted that not every transaction that involves a cash transfer is subject to VAT. For example, a penalty or indemnity for damages are not payments for taxable supplies and thus not subject to VAT.

Registration for VAT

According to the Czech VAT Act, the taxable persons must register for VAT if they exceed the **turnover** of CZK 2 mil in 12 successive months. In other member states, the registration threshold could be different. The taxable person who exceeded the threshold is obliged to file the registration form within 15 days following the end of the month in which the registration limit was exceeded. They become VAT payers from the first day of the following month. For example, if they exceed the threshold in August, they register on 15th September and become VAT payers on 1st October. After their registration, the VAT payers must apply the output tax on all the goods or services they supply to their customers. At the same time, they can claim the input VAT deduction in respect of the purchased goods and services. They must file their **VAT returns** monthly or quarterly, depending on their annual turnover. In their tax returns, they declare their **VAT liability** or **excessive deduction**.

You should also know how to calculate the turnover, which is decisive for VAT registration. The turnover includes all payments for taxable supplies, exempt supplies with credit, and certain exempt supplies without credit[9]. On the other hand, it does not include the sales of capital assets[10], prepayments on supplies not yet delivered, and supplies outside the Czech Republic.

There are also other situations where a taxable person must register for VAT as a VAT payer or, in certain cases, as an **identified person**. Some of these cases will be discussed in the chapter on international transactions. You should also note that any taxable person can apply for a voluntary VAT registration.

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[9] Financial and insurance services and transactions in immovables but only if they are performed on a continuous basis.

[10] Long-term assets with the acquisition price higher than CZK 40,000.

Discussion questions:

1. Why should a taxable person apply for voluntary VAT registration? Usually, people do not want to pay more taxes than necessary.
2. Why are sales of capital assets excluded from the turnover calculated for the purpose of the VAT registration?

8. The Scope of VAT, Tax Base, Rates and Exemptions

This chapter covers important information on the scope of VAT, which would help us to answer the question: What transactions are subject to VAT? Furthermore, we will learn how the VAT on each supply is calculated. For this calculation, we will use the rules for determining the VAT amount and applicable rate or, in some cases, exemption from the VAT.

Scope of VAT

As already explained, the VAT is imposed on consumption. Generally, all **goods and services supplied** are subject to VAT. The Czech VAT is only levied on goods and services supplied for consideration by a taxable person acting as such **within** the territory of **the Czech Republic.**

Moreover, goods acquired from other member states or **imported from third countries**[11] are usually also taxed in the Czech Republic. There are specific rules regarding the persons who are liable to pay VAT on the **acquisition** of goods **from the EU** and third countries. Taxation of imported goods is necessary so that local producers, who are obliged to levy VAT on their sales, are not discriminated. VAT follows the so-called destination principle stipulating that the goods and services should be taxed where they are actually consumed. Therefore, the exports of goods are usually exempt from VAT. For the cross-border provision of services, the place of taxable supply is shifted to the country of consumption. This will be discussed in more detail within the chapter on international transactions.

Transactions within the scope of VAT can either be taxed or exempt. Two types of exemptions apply, one **exemption** is **with credit** and the other is **without credit**. In both cases, the goods or services supplied are exempt from VAT, which means that the output VAT does not have to be accounted for by the supplier. The difference between those two types of exemption lies in the right to recover the input VAT on associated purchased supplies. As you probably guessed, taxpayers rendering the exempt supplies with credit are allowed to claim the input VAT deduction on purchased goods and services whereas the suppliers of exempt goods or services without credit cannot recover their input VAT.

Some supplies, specifically listed in the VAT Act, are **outside the scope** of VAT although they fulfil the definition of a taxable transaction. As example could be the transfer of a business as

[11] Countries outside the EU are referred to as third countries within the VAT legislation.

a going concern or a transfer of a receivable that is not subject to VAT, even if supplied for consideration and within the economic activity of the supplier.

On the other hand, we can find certain transactions that do not fulfil the legal definition and still are subject to VAT. The **free-of-charge supplies** to employees (e.g. various employee benefits or gifts) are the most common examples. Such goods or services are provided for no consideration. Despite this, they are subject to VAT. This rule is implemented in order to avoid potential discrimination that would arise between employees receiving a non-taxed benefit and normal customers, purchasing the same goods or services on the market with VAT.

For the correct application of VAT, the supply of goods and services is distinguished. There are different rules for these two categories in the application of the VAT rates, the determination of the tax base, the date of taxable supply, and the place of supply. The category of **goods** includes all movable or immovable things. Note that gas, heat, electricity, and water are also goods for VAT purposes. **Services** are defined as any transactions that do not constitute supplies of goods, including the assignment of intangible property and the obligation to refrain from or tolerate an act or situation.

VAT rates

Due to the EU harmonisation of the VAT, the member states are bound by certain common rules regarding the VAT rates and exemptions implemented in their local VAT legislation. The VAT Directive stipulates that member states must apply a **standard rate** on both the goods and the services, which may **not** be **less than 15 %.** They may also apply either one or two **reduced rates**. The reduced rates may **not** be **less than 5 %** and they may only apply to the categories of goods and services specified in Annex III and IV of the VAT Directive. However, many member states agreed on certain exemptions to these rules and they apply reduced rates to supplies other than those listed. The structure of the VAT rates is rather a political question and countries use the rates in their tax systems for various purposes, e.g. social support by applying reduced rates on pharmaceuticals or foodstuffs, etc.

In the Czech Republic, the standard rate of 21 % is quite high as well as the first reduced rate of 15 %. The goods subject to the **first reduced rate** include e.g. foodstuffs, non-alcoholic beverages; take-away food; medical equipment for disabled persons; children's car seats; firewood; some agricultural supplies; and cut flowers and plants for decorative use.

The services subject to the first reduced rate are e.g. Work of writers and composers; social housing (new flats up to 120m2 and family houses up to 350m2); the renovation and repair of private dwellings; social services if not exempt; medical and dental care if not exempt; airline passenger transport (if not exempt); domestic waste collection and street cleaning repairs.

There is also the **second reduced rate** of 10 % applied for example on selected baby food and gluten-free food; water supplies; gas and heat; newspapers and periodicals; most pharmaceutical products; and most books (including e-books). Furthermore, the following services are also taxed at a second reduced rate: regular domestic passenger transport (bus and trains); admission to cultural events, shows, and amusement parks, admission to sporting events; use of sporting facilities and wellness; restaurant and catering services, accommodation services; cleaning of private households; domestic care services.

VAT base and calculation of VAT

If a taxpayer's transaction falls within the scope of VAT, s/he must calculate the respective VAT for each individual supply of goods or services. The base of the calculation is sometimes also called the **VAT amount**. In most cases, the VAT amount is equal to the consideration obtained or to be obtained by the supplier from the customer or a third person. The VAT amount includes subsidies directly linked to the price of the respective supply. Such consideration can be in **monetary** or **non-monetary** form (barter transactions). In the latter case, the VAT amount equals the usual market price of the goods or services supplied.

The VAT amount also includes any taxes, duties, levies, and charges excluding the VAT itself. Furthermore, incidental expenses such as a commission, packing and transport, or insurance costs charged by the supplier to the purchaser are included as well. On the other hand, excluded are the monetary amounts charged to customers, which were incurred as an expense by the supplier on the customer's behalf and in his/her name[12]. The tax base is also reduced by any discount provided prior to the delivery of the goods or provision of services. If a discount is allowed after the date of the taxable supply, the tax amount can be corrected by a corrective tax document, which must be delivered to the customer.

In most cases, the VAT is calculated as a percentage equal to the applicable **VAT rate** applied to the price-exclusive VAT, i.e. the VAT amount. Sometimes the price agreed with the customer

[12] For example, a notary fee paid by the lawyer on behalf of his/her client to the notary and then charged to the client.

already includes VAT. The relevant VAT in such a situation is the difference between the price-inclusive VAT and the price-exclusive VAT, which is computed by dividing the price-inclusive VAT by 1.21 for the standard rate, 1.15 for a first reduced rate, and 1.1 for the second reduced rate. For example, if the price is agreed at CZK 1,000 including the VAT and the standard rate is applicable, the VAT included in the price is calculated as follows:

$$VAT = \text{ } Price\ inclusive\ VAT - Price\ inclusive\ VAT/1.21$$

The above "to-down" method of VAT calculation is also used for pre-payments which are usually inclusive of the VAT. As mentioned in the previous chapter, free-of-charge supplies may be subject to the VAT, such as e.g. private/non-business uses of goods. In such a case, the VAT amount is determined as the usual market price of the goods or cost price for the provision of services.

Date of taxable supply

Following the calculation of the VAT applicable to each supply, each taxpayer must also decide to which tax period each supply of such goods or services belongs. S/he must ascertain the date of the taxable supply, sometimes also referred to as the **tax point** for each transaction. The VAT legislation specifies the rules for determining the tax point for various types of supplies. Generally, the VAT is chargeable when the goods are delivered or the services are performed[13]. If a payment is made before the given supply takes place, the VAT becomes chargeable on the receipt of the **prepayment**. Note that different rules apply to international transactions. These will be described later. The taxpayer is obliged to issue an **invoice** within 15 days of each supply.

The question of when the VAT becomes payable by the supplier is closely related to the moment when the purchaser can deduct it as his/her input VAT. The right to the deduction is tied to the time when the supplier is obliged to charge the output VAT. This prevents financing the VAT recovered by purchasers from the Treasury. In Chapter 9, we shall learn about further conditions for the VAT recovery.

[13] For services, it is also the issuance of the invoice before their actual provision that may trigger the VAT chargeability.

VAT exemptions

As discussed earlier, the exemptions are divided into two groups. At this point, we will discuss only the exemptions without credit since the exemptions with credit relate almost exclusively to international transactions that will be covered in a special chapter.

The **exemptions without credit** are again split into two categories according to the VAT Directive. The first category includes **activities in the public interest**, inter alia postal, medical, social, educational, and cultural services. These activities are exempt from tax, so VAT does not increase their price. It is not desirable to raise the prices of activities pursuing social purposes such as those related to the protection of human health, etc. Even more so, if they are conducted by bodies governed by public law and financed from public budgets.

The **second category of exemptions** includes e.g. financial and insurance services, betting and lotteries, supply of buildings and land on which they stand, and letting and leasing of immovable property. These exemptions are implemented **for various reasons**. For example, financial services are considered difficult to tax due to the complicated determination of a correct tax base. However, this reason has recently lost much of its relevancy as the data processing developed since the original implementation of these VAT rules (i.e. around 1970).

Sales of undeveloped land except for building plots (i.e. lands on which building permissions have been issued) are always exempt. **Transfers of buildings** and the land on which they stand are exempted after 5 years from the approval of the buildings to use or their first use. However, the VAT payers may opt for taxation of the buildings and the associated land even if the 5-year period elapses. The option to tax is also allowed for the letting and leasing of immovable property on the condition that the tenant is a VAT payer and uses the leased premises for his/her economic activity.

Discussion questions:

1. Why should a VAT payer opt for taxation (for example if renting the building) if his/her transaction is VAT exempt?
2. Why do you think the reduced rates are applied to the accommodation and restaurant services?

9. VAT on Cross-border Transactions

This chapter is aimed at international transactions and their VAT treatment. We will concentrate on the supplies of goods to and from abroad and we will also deal with the provision of services to and from foreign countries.

The fundamental principle followed in the international VAT is the effort to tax all goods and services in the country where they are consumed. This principle is called the **destination principle** and you probably find it quite logical as the VAT is a consumption tax. The destination principle is followed in the case of transactions between taxable persons (entrepreneurs). On the other hand, the goods supplied to non-taxable persons (e.g. private persons) within the EU are taxed in the country where they come from. In such a situation, the **origin principle** is used.

As you remember, only the goods and services supplied within the territory of the Czech Republic are subject to the Czech VAT. Therefore, when deciding whether to apply the output VAT on a certain transaction, we must determine the **place of supply** for such a transaction. If the place of supply is in the Czech Republic, the transaction is taxable in the CR. Should the place of supply be in another EU country or outside the EU, such a transaction is out of the scope of the Czech VAT.

The VAT Act as well as the European VAT Directive stipulate the place of supply rules for goods and services differently. Therefore, the following text is split into two parts covering separately the treatment of the supply of goods and the provision of services.

Supply of goods

Rules governing the place of supply for goods

For goods, the basic rules are as follows:

1) If the goods are dispatched or transported, the place of supply is the place where the transport begins.
2) If the goods are not transported, the place of supply is the place where the goods are located at the moment of the supply (i.e. usually the transfer of the ownership[14]).

[14] In some situations, the supply occurs prior to the legal transfer of the ownership or after it (e.g. supplies of consignment stock).

3) If the goods are installed or assembled, the place of supply is the place where the installation or assembly is accomplished.
4) If the goods are supplied on board of ships, aircraft, or trains during passenger transport within the EU, the place of supply is the first place in the EU where the passengers can get using this means of transport.
5) If immovables get transferred, the place of supply is the place where the given immovable (e.g. building or land) is situated.
6) If the electricity, gas, heat, or cooling energy is supplied, the place of supply is where the purchaser (if s/he is a trader) is seated, or where such electricity, gas, heat, etc. are consumed.

After examining the rules above, you probably notice that not all the situations follow the destination principle. Actually, the most common situation where the goods are transported from the supplier to the customer indicates that the goods are taxed where the transport begins, which is most probably in the country of the supplier (i.e. the country from where the goods originate). We shall further focus on this most common case of the supply of goods.

Although the place of supply of the **goods transferred to other EU member states** or to third countries is in the country of origin, the destination principle is still ensured by the exemption of such a delivery. The cross-border supplies of goods and exports **are** usually **exempt with credit** in the country of dispatch and the purchaser applies the tax on the acquisition of such goods in another member state (or on import in third countries outside the EU[15]).

<u>Conditions for exemption of supplies of goods abroad</u>

The supply of goods to another member state, the so-called **intra-community supply**, is exempt only if the **goods are transported** or dispatched by, or on behalf of, the vendor (seller) or the purchaser **out of the Czech Republic**. The vendor must record the sale to another member state in his EC Sales list (a document that is filed together with the VAT return). Furthermore, the person acquiring the goods (purchaser) must be a taxable person registered for the VAT in the state of the acquisition. **The acquisition of goods** by the customer must be **subject to VAT in the country of destination**. Therefore, the customer must pay the VAT from the acquisition of the goods at the rate applicable in his/her country. The transport of the goods should be proved by appropriate documents (e.g. fright bills confirmed by the carrier). The status of the customer should be evidenced by the VAT identification number assigned to

[15] If the VAT is implemented in such countries (usually some tax is levied on imports).

him/her in the member state where the goods were acquired. If the customer is, for example, a private person, the goods would be taxable in the Czech Republic, or more generally in the country of origin, using the VAT rate applicable on such goods in the Czech Republic. Thus, **in the transaction with a non-taxable person**, the **origin principle** would be followed.

Similar conditions apply to the **export of goods** (i.e. deliveries outside the EU). The goods must be transported from the EU by or on behalf of a vendor or the person purchasing the goods on condition that such a person does not have a seat, residence, or fixed establishment in the Czech Republic. In this case, the exporter does not need the transport documentation as **proof for the dispatch** of the goods because s/he can obtain more powerful evidence in the form of a "stamp" on the **customs declaration** from the customs authority[16].

<u>Taxation of intra-community acquisitions and imports</u>

As you have learned above, purchases of goods from abroad are usually taxed in the country of destination. The following section shows how this taxation is actually achieved.

In the most common case, a VAT payer purchases goods from a person registered in another member state and s/he applies the output VAT of his/her country on the acquired goods. As already mentioned in the chapter on the scope of VAT, **the acquisition of goods from the EU** is **subject to VAT in the Czech Republic**. At the same time, the VAT payer is entitled to deduct the VAT paid on the acquisition of goods as long as s/he uses the purchased goods for his/her taxable transactions or other transactions eligible for the VAT deduction within his/her economic activity.

If a Czech taxable person, who is not registered as a VAT payer, purchases goods from a person registered for VAT in another member state and these **purchases exceed CZK 326,000** in a calendar year, such a person must register for VAT and becomes the so-called **identified person**. This could be a situation of a small entrepreneur not exceeding the obligatory threshold for the VAT registration or a non-taxable legal person, e.g. charities, or public bodies.

Such a person must apply the output VAT on the acquisitions of goods from the EU but does not have the right to claim this VAT back. Of course, it could be more advantageous for such a person to register for the VAT as a VAT payer in order to recover the input VAT. The decision would depend on the scope and character of his/her other activities, the position of such a person

[16] The customs declaration is made in electronic form so the "stamp" is meant as an electronic confirmation.

in the distribution chain, etc. Note that the **acquisition of new means of transport**[17] and **goods subject to excise duty** would trigger the taxation regardless of the CZK 326,000 threshold mentioned above.

Imports of goods are subject to tax in the Czech Republic with certain exemptions (e.g. imports by travellers in air transport up to the limit of EUR 430) even if non-taxable persons or VAT non-payers make them. In such a case, the VAT is paid to customs authorities. If the goods are imported from outside the EU by VAT payers, the import VAT is paid to the financial authorities through the VAT return. The VAT payer must apply the output VAT on the imported goods and has the right to deduct this VAT from his/her total output VAT as long as s/he uses the imported goods for his/her transactions eligible for VAT deduction, similarly as in the case of the intra-community acquisitions.

Provision of services

The destination principle is also followed in transactions involving the provision of services. However, the VAT treatment is slightly different as we shall see in the following text. Unlike the cross-border supplies of goods, the services provided abroad are not exempt with credit[18]. The services are usually taxed in the country of consumption, due to the **shift of the place of supply to the customer**. You could see a similar rule for the supply of electricity.

<u>Rules governing the place of supply rules for services</u>

The **basic rule** for the services provided between taxable persons stipulates that the place of supply is **where the recipient** of the service **has established his/her business** or has a fixed establishment to which the services were supplied. These transactions are sometimes called **B2B services**; this abbreviation means business-to-business transactions. The **basic rule** for the provision of **services to non-taxable persons** is opposite to the previous one. The place of supply of such services is situated at **the seat of the supplier** or at his/her fixed establishment through which the services were provided. You can recognise the origin principle in the latter case.

[17] New means of transport are new cars, boats and planes fulfilling certain conditions. They are always taxed based on destination principle; therefore, slightly different rules apply in their respect.

[18] With one exception, the work on goods (e.g. repair or processing) provided to third countries.

We have used the term **fixed establishment** already twice so it should be explained. It basically means a fixed place that permanently possesses the human and technical resources required to receive and use the given service.

There are numerous **exceptions to the basic rules**. We list only a few that relate to B2B transactions. The remaining rules for the services supplied to non-business customers (B2C transactions) can be found in the Czech VAT Act or the VAT Directive or VAT Regulation.

1) The place of supply of **services related to immovables** is determined based on where the given immovable is located. Included are the services of the estate agents, experts, and architects, accommodation, construction works, etc.
2) The place of personal **transport services** is where the transport takes place, proportionately in terms of the distances covered.
3) The place of supply of **cultural, artistic, sporting, scientific, educational, entertainment, and similar activities** is where such services are physically carried out.
4) The place of supply of **restaurant and catering services** is the place where these services are carried out.
5) The place of the **short-term lease of the means of transport** is the place where it was handed over to the customer. The short-term lease cannot exceed 30 days (for cars, buses, etc.) and 90 days for ships and boats.

The place of supply for B2B transactions is in many cases shifted to a country different from where the supplier established his/her business and is VAT registered. If s/he provides services with the place of supply in different countries, s/he should potentially register in those countries and pay the VAT in respect of his/her supplies there.

<u>Reverse-charge mechanism</u>

The **reverse-charge mechanism** is applied to avoid the registration of international suppliers of services in all the countries where they have their customers[19]. We have already encountered this system within certain local supplies, discussed earlier (e.g. construction services).

Generally, services do not get value-added taxed by suppliers and the **supplier invoices the service without the output VAT**. The person who is liable for the tax in this transaction is **the**

[19] or provide services subject to exceptions (e.g. services related to immovables) that lead to the shift of the place of supply to a different country.

customer (the recipient of the service). Therefore, s/he **applies** the **output VAT** in the country where the service is consumed and reports it in his/her VAT return in his/her home country. At the same time, s/he can deduct this VAT if s/he uses the purchased service for his/her taxable transactions or other transactions bearing the right to recover the input VAT.

Shifting the place of supply of the service to the customer means that the supplier does not apply the output VAT in the country of origin. A logical question could arise, whether the same **conditions** as those **for the exemption** of exports and intra-community supplies of goods exist for services. Of course, the **customer must be a taxable person** so that s/he is able to apply the output tax on the purchased service. Therefore, the supplier should have evidence of the status of his/her customer. At the first moment, it does not necessarily have to be the **VAT number**. The customer could be a taxable person who had not been registered yet (e.g. due to a small turnover). But after s/he purchases the services from abroad, s/he should register for the VAT at least as an identified person[20]. Consequently, s/he receives an identification number that s/he would provide to his/her supplier.

Discussion questions:

1. Do you know the rules that apply to distance sales when the taxable person supplies the goods to non-taxable persons in other EU member states? Take an example of an e-shop selling CDs from Slovakia to private persons in the Czech Republic.
2. What is the main difference between the rules of the place of supply applicable to goods and services?

[20] Similar situation to the purchase of goods over CZK 326,000 from the EU by a VAT non-payer.

10. VAT Recovery and VAT Refunds

In this chapter, we shall discuss the right to the VAT deduction exercised by the VAT payers. This is an essential right in the VAT mechanism because it ensures its neutrality, as explained previously. The main rule is that each VAT payer has the right to deduct the input tax invoiced to him/her in respect of his/her purchases from the output tax for which s/he is liable in respect of his/her supplies.

Rules for the VAT deduction

The right to claim the input VAT arises at the moment when the deductible tax becomes chargeable by the supplier. This means basically on the **day of the payment or the tax point** whichever occurs earlier. To prevent the temporary financing of VAT claims from the state budget, the recipient of the supply can only deduct the input VAT after s/he receives the **invoice**. There is an exception to this rule: when the reverse-charge mechanism applies, the purchaser does not have to possess the VAT document as s/he applies the output VAT himself/herself. The input VAT can be claimed within three years of the date when the VAT became chargeable except for the VAT payers who reduce their VAT using the coefficient. For example, if a VAT payer finds an old invoice issued 2 years previously on which by mistake no input VAT was claimed; s/he can still recover this VAT within the normal VAT return.

An important rule is that the VAT payer can only claim the input VAT on the purchased **goods and services used in his/her economic activity**. Within the economic activity, they must be used for making taxable supplies[21] or supplies exempt with credit. To prove the input VAT entitlement, the VAT payer must possess the invoice issued by his/her supplier, who is also a VAT payer. The recipient of the supply can only deduct the correct amount of VAT. If the supplier applies e.g. the standard VAT rate instead of the reduced rate on the invoice, the purchaser can only deduct the VAT corresponding to the reduced rate.

Allocation of input VAT

If the VAT payer buys goods or services from another VAT payer, s/he should decide whether the purchased supply is to be used for his /her economic activity. In case the goods are purchased as a gift to a charity or for personal purposes of the entrepreneur, these goods are not

[21] Including taxable transactions in another country, provided the transactions would be eligible for deduction of tax had they occurred in the territory of the home country.

being used within the economic activity at all. Therefore, no input VAT can be claimed on such purchases according to the main rule mentioned above.

It can also happen that purchased goods or services are **partly used** for an **economic activity** and partly for a non-economic activity. The employer may provide his/her employee with a car that can be used for business trips as well as for private journeys. In such a case only a part of the VAT corresponding to the business use can be claimed. The **proportion is calculated** e.g. based on the number of km driven for business and private purposes. The law does not strictly stipulate the method but it should be reasonable so that the taxpayer can defend it in the case of an audit by the financial authorities.

Some VAT payers are **partially exempt**. This means they are engaged in taxable transactions as well as in activities exempt from the VAT without credit (i.e. no right to the VAT deduction). They must **attribute their input supplies** to their output supplies based on how the input supplies are used. If the supplies are used for making exempt supplies without credit, for example, financial transactions or transactions in immoveable property, the input VAT incurred on such supplies cannot be recovered at all. We can use an example of the VAT incurred on the repair of a building, which is let to tenants. As the lease of a building is VAT-exempt without credit (unless the lessor opts for taxation), the input VAT charged on the invoices for the construction works cannot be claimed by the building owner.

On the other hand, the input VAT incurred on goods and services employed in rendering taxable supplies can be claimed in its total amount. If someone produces furniture and buys material for his/her production, s/he can recover input the VAT incurred on timber, nails, bolts, and whatever s/he needs for making his/her products.

Apportionment of input VAT

Sometimes the purchased supplies are used partly for making exempt supplies without credit and partly for taxable transactions. We can call such purchases **"mixed supplies".** If they **cannot be allocated directly** to taxable or exempt output supplies, the input VAT incurred on such purchases must be **apportioned** based on a **coefficient**. This coefficient is calculated as a proportion of the turnover for all the supplies bearing the right to the input VAT deduction to the total turnover including the exempt supplies without credit.

The apportionment of the input VAT would be applicable e.g. for the partly exempt VAT payers (e.g. posts, banks, insurance companies, hospitals, schools, etc.). We can imagine a bank carrying on various financial activities that are exempt from the VAT without credit and some taxable activities, e.g. financial advisory. If the bank purchases a new computer for its accounting department, only part of the input VAT included in the price of the computer could be claimed.

The proportion of the input VAT to be recovered is calculated as the total amount of the input VAT incurred on all the "mixed" supplies in a taxable period multiplied by the coefficient equal to:

$$\frac{taxable\ supplies + exempt\ supplies\ with\ credit + other\ supplies\ eligable\ to\ input\ tax\ deduction}{total\ supplies\ in\ nominator + exempt\ supplies\ without\ credit}$$

Other supplies eligible for the VAT deduction to be included in the nominator of the fraction cover inter alia the supplies performed outside the Czech Republic. But only those entitling the VAT payer to claim the input VAT on the related input supplies if carried on within the CR. We can name as an example services provided to a business customer in other EU member states that have their place of supply in the country of the customer.

Financial and insurance services related to exports or provided to foreign persons outside the EU also bear the right to deduct the input VAT on the related purchases, even though such services when provided locally or to the EU customers are VAT-exempt without credit. Therefore, these financial and insurance services are also part of the nominator[22].

As the annual turnover for taxable and exempt activities is not known until the end of the calendar year, an **advance coefficient** is used for the apportionment of the input VAT during the year. The advance coefficient is equal to the final coefficient calculated for the previous year. At the year-end, a **reconciliation of the input VAT incurred on the "mixed" supplies** is made using the actual coefficient calculated from the figures of the current year. If the new coefficient is higher than the advance coefficient, the VAT payer can claim the difference between the input VAT claimed during the year and the input VAT calculated by the new coefficient in the last taxable period. If the new coefficient is lower than the advance coefficient,

[22] Except from them, the nominator also includes certain transactions not subject to VAT as for example transfer of business as a going concern or the assignment of a receivable.

a part of the input VAT on the “mixed” supplies claimed during the year must be repaid to the financial authorities.

Capital assets scheme

For **capital assets**[23] purchased for use within the economic activity, the input VAT can be claimed in the full amount. This is the difference from the income tax where the costs incurred on capital assets cannot be expensed in the year of the purchase, but the acquisition price must be written off over the depreciation period as stated by the income tax legislation. However, the longer period of use of the capital assets is also reflected in the VAT rules.

The VAT payers have to **monitor the usage** of their capital assets and if it changes in the way that the particular asset is no longer used for activities eligible for the VAT deduction, they are obliged to repay a part of the input VAT claimed at the time of the purchase of such an asset. The exploitation of the assets is being watched **for 5 years** and in the case of **immovables, for 10 years**. The VAT to be paid back should be calculated as one-fifth, and for immovables as one tenth, of the input VAT originally deducted. If the asset is still partly used for taxable activities, only a part of the input VAT attributable to the exempt usage must be repaid. If the situation is the opposite and the assets were purchased for the exempt (partly exempt) purpose but subsequently used within taxable transactions, the VAT payer has a right to increase the input tax originally (non)deducted on the asset.

The **formula** for the calculation of the VAT to be returned/reclaimed in the situation where the asset is used in other way than anticipated at its purchase reads as follows:

$$\frac{input\ VAT\ originally\ claimed\ \times (coef_t - coef_{t0})}{5}$$

$Coef_{t0}$ represents the proportion of the input VAT initially claimed. In case the full amount of the input VAT incurred on the asset was deducted, the $coef_{t0}$ is 1. If only 50% of the input VAT was claimed because the asset was meant to be used for taxable and exempt purposes, then $coef_{t0}$ is 0.5. $Coef_t$ is the proportion of the input VAT entitlement according to the new usage of the asset. If the asset is newly used only for exempt supplies without credit, $coef_t$ is 0. If it is used for taxable and exempt activities, the $coef_t$ is equal to the annual coefficient for the apportionment of input VAT.

[23] Tangible long term assets with the acquisition price higher than CZK 40,000, intangible assets with value over CZK 60,000 and land.

The input tax on assets purchased for both taxable and exempt use may have to be corrected should the difference in the current year‘s coefficient and the originally used coefficient reach 10 p.p. or more.

Once again we may use the **example** of the computer purchased by a bank. Supposing the computer was used in the accounting department and the bank’s coefficient in the year of purchase was 30 %, the input VAT on a computer costing CZK 100,000 would be CZK 21,000. From this amount, only 30 %, i.e. CZK 6,300 could have been claimed. In the second year, the bank reached a higher coefficient of 50 %. Therefore, the input VAT deducted from the computer can be corrected. The bank can increase its input deduction for the last tax period of the second year by 21,000 x (0.5−0.3)/5 = CZK 840.

There is also a scheme for the **settlement of the input VAT deducted on inventory or small assets**. If the originally intended usage of these assets changes, the VAT payer is obliged to pay the input VAT back in the full amount or only partly, depending on the nature of the new use. The inventory of drugs bought by a pharmacy could be used as an example. If it is meant for further sale, the input VAT is deducted in full. In case some of the pharmaceuticals are used in a hospital as a part of health care, the originally deducted input VAT must be paid back.

VAT refunds for foreign persons

The VAT incurred by foreign persons on purchases of goods and services in the Czech Republic can be under certain conditions refunded to them. As they are not Czech VAT payers, they cannot claim the input VAT through their VAT returns. Basically, three situations exist.

1) **Entrepreneurs** (taxable persons) **from the EU** who are registered for VAT in their home country can apply for the VAT refund of the Czech VAT incurred on their purchases in the Czech Republic through an electronic portal. Such persons are entitled to the VAT refund under **similar rules as the Czech VAT payers** claim the input VAT. They also have only a partial entitlement if they carry on some exempt activities in their home country. The VAT should be refunded within 4 months from the request which can be submitted for the period of at least 3 months (maximum 1 year).

2) **Entrepreneurs** (taxable persons) **from outside the EU** can ask for a refund once a year, they must do it in paper form and the VAT is repaid within 6 months from the

application. Their entitlement is quite restricted as it is based on **reciprocity**[24] and the VAT is refunded only in respect of some goods and services. For example, costs for transport, phone calls, taxis, fuel, accommodation, and restaurants are not included.

3) **Tourists** or other non-taxable persons **from outside the EU** are entitled to VAT refunds in respect of the goods purchased in the Czech Republic and exported within 3 months from the purchase. The condition is that each individual **purchase must exceed CZK 2,000**, the export of the goods must be confirmed by the customs authority and the goods should not be intended for commercial purposes. Moreover, foodstuffs, alcohol, tobacco products, and fuels are excluded from the VAT refund. This refund is not claimed from the Financial Authorities as in the previous two situations but directly from the suppliers of the goods (Czech VAT payers). Usually, the refund is processed by specialised firms applying for the refund on behalf of the tourists leaving the Czech Republic. In most cases, such firms have their offices at the airport.

Discussion questions:

1. Why do you think the refund for EU-taxable persons is more generous than the refund to persons from third countries outside the EU?
2. Why is the right to deduct input VAT for each taxpayer so important?

[24] This means that the Czech Republic only refunds the VAT to persons from countries that refund their VAT to the Czech businesses or countries where no VAT is imposed.

11. Excise Duties

This chapter provides you with basic information on excise duties. Similarly to the VAT, this area of taxation is **harmonized within the EU**. Hence the rules applicable in the EU and the Czech Republic are almost identical. The Excise Duties Act of the Czech Republic follows the European Directives on excise duties. These include the Horizontal Directive[25] covering general rules on the movement and holding of excisable products. Furthermore, each group of products that are subject to excise duty is dealt with within one or more structural Directives[26] stipulating the applicable tax bases and tax rates.

The excise duties are probably the oldest taxes. Products subjected to excise duties are usually harmful to either human health or the environment. Excise duties should reduce the consumption of such products. Therefore, they are sometimes called corrective taxes. However, their main purpose is the fiscal one. Excise duties represent around 12 % of the total revenues of public budgets in the CR.

Excisable products

The goods on which the excise duty is levied can be divided into the following groups.

1) **Energy products** containing mineral oils, coal, natural gas, and electricity.
2) Manufactured **tobacco**, including **cigarettes**, **cigars, cigarillos**, fine-cut tobacco, heated tobacco products, and other smoking tobacco.
3) **Alcoholic beverages** comprising wine, beer, and ethyl alcohol.

Note that energy products are regulated by two different pieces of legislation in the Czech Republic. The Excise Duties Act deals with the mineral oils used as propellants and for heating but other energy products, i.e. **electricity, natural gas,** and **coal** are covered by the specific legislation on Energy taxes.

In this chapter, we shall only cover mineral oils. For details on the taxation of electricity, coal, and natural gas see either the relevant Czech legislation or the EU Directive on Energy Products.

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[25] Council Directive 2008/118/EC concerning the general arrangements for excise duties.

[26] For example Council Directive 2011/64/EC on the structure and rates of excise duty applied to the manufactured tobacco or Council Directive 2003/96/EC restructuring the Community framework for the taxation of energy products and electricity. All the Directives can be found on http://ec.europa.eu/taxation_customs/taxation/excise_duties/index_en.htm.

Tax base and rates

The **tax base** is **specific**, which means that for each supply of excisable goods, the tax base is determined in units. The units differ according to the type of the product. For mineral oils, the tax base is measured in 1,000 litres at 15°C. The tax base for alcoholic beverages is usually stated in **hectolitres** (hL) taking into account the strength of the alcohol as well. For example, if we supply 1 hL of a 40% spirit, the tax base would be 0.4 hL. For 1 hL of 10° beer, the excise duty would be calculated from 10 hL (1 hL times 10). Tobacco for smoking has the tax base determined in **kilograms** (kg) and cigars and cigarillos in **pieces**.

In all the cases mentioned above, the tax **rate** is **fixed** and expressed in Czech crowns (**CZK**). The other type of tax rate is **ad-valorem** rate which is expressed as a **percentage**. Such a rate is applied to cigarettes, as we shall see later. However, the fixed rate does not mean that it is the same for all kinds of mineral oils, alcoholic beverages, and tobacco products. The rates are differentiated based on the product and its particular use. Some examples of excise duty rates are mentioned in the following table.

Table 1: The tax rates for selected excisable goods applicable in 2021

Excisable product/use of products	Tax base	Tax rate in the CR
Unleaded Petrol	1 000 l	12 840 CZK
Gas Oil	1 000 l	9 950 CZK
LPG as propellant	1 000 l	3 933 CZK
LPG for industrial use	1 000 l	1 290 CZK
Beer	hl/ degree of Plato	32 CZK
Wine	hl	0 CZK
Sparkling wine	hl	2 340 CZK
Spirits	hl of pure ethyl alcohol	32 250 CZK
Cigars and cigarillos	100 pieces	229 CZK
Fine Cut Tobacco	1 kg	3 000 CZK
Cigarettes per piece	1 piece and price of a package	1.97 CZK, 30 %
Minimum rate for cigarettes	1 piece	3.52 CZK

Source: Czech Excise Duties Act.

In almost all cases (except for cigars and cigarillos), excise duty rates in the Czech Republic exceed the minimum rates required by the EU.

You may notice that LPG is taxed at a higher rate if used as a propellant rather than for industrial **purposes**. This difference in the tax rates supports industrial purposes in contrast to the usage as driving fuel. The tax rate can also be **differentiated** by remitting a certain amount of tax if the product is used for specific purposes. For example, if the gas oil is used for heating, a part of the excise duty paid in the purchase price is remitted after providing the appropriate documentation of usage. The effective rate for gas oil when used for heating purposes in turn equals CZK 660 per 1,000 L.

For beer, the rate is **differentiated** based on the **size of the brewery** where it was produced. Small breweries have reduced rates. For example, the brewery that produces less than 10,000 hL per year is entitled to apply the tax rate of CZK 16 per hL/Decree of Plato.

A different approach is taken for **cigarettes**. The **specific** part of the excise duty is computed per unit of the product and a **proportional** excise duty gets calculated on the basis of the retail selling price.

Example 1: Calculation of excise duty on cigarettes

For a pack of 20 cigarettes sold for CZK 150, the excise duty would be calculated as follows:

EXCISE DUTY	**TAX BASE**	**TAX RATE**	**TAX CALCULATION**
THE SPECIFIC PART	Number of cigarettes in the pack − 20 pieces	CZK 1.97	1.97 x 20 pieces = 39.40
THE AD-VALOREM PART	The price for the customer is CZK 150	30%	30 % x CZK 150 = 45
TOTAL EXCISE DUTY	Specific plus ad-valorem part		39.40 + 45 = 84.40
MINIMUM EXCISE DUTY	20 pieces	CZK 3.52	3.52 x 20 pieces = 70.40

Source: Czech VAT Act and Own calculations.

The total calculated excise duty is CZK 84.40. The Czech legislation also stipulates the minimum rate applicable on cigarettes in the amount of CZK 3.52 per piece. Therefore, we must compare the calculated excise duty with the minimum amount. As the minimum excise duty is lower than the figure computed from the actual price of the pack, the calculated tax can be applied. The pack will be therefore taxed by the excise duty of CZK 84.40.

Taxable event and chargeability of tax

The excise duty is payable on all the products mentioned above, whenever these are produced on, or imported to, the territory of the EU. However, the chargeability of the tax is postponed to the moment when the goods are released to "**free circulation**".

The collection of excise duties is different from the VAT system. The excise duty is paid within the distribution chain only once. In contrast, as you remember, the VAT is paid consecutively by each supplier in the distribution chain by applying the output VAT on his/her sales and deducting the input VAT paid on his/her purchases. As long as the goods are stored in the **tax warehouse** or transported within the **suspension system**, the excise duty does not have to be paid. Only once the goods are sold to a customer who is not permitted to operate the tax warehouse or who is not the **registered recipient**[27], the goods have to be released to "free circulation". At this moment, the excise duty must be reported in the tax return. The **tax returns** are filed **monthly** (within 25 days following the end of the month) and separately for each type of excisable goods.

For instance, the producer of petrol and spirits would file two different tax returns to the customs authorities. The excise duty applied on all the supplies of **petrol** that were released from the tax warehouse within a month's period would be payable by the 40th day after the end of that month. The excise duty on **spirits** supplied (and released to the free circulation) within that month would be payable by the 55th day from the end of that month. However, the deadline varies for individual excisable products. For **cigarettes,** it is the 60th day after the order for cigarettes stickers has been made.

Tax warehouses and suspension procedure

In the last paragraph, we have mentioned the term suspension system. Let us explain it. All the producers of excisable goods must have a registered tax warehouse. Such a place is under the supervision of customs authorities and the excise duty payable on the goods produced and stored in the **warehouse** must be guaranteed by the warehouse keeper. The goods can only be transported to another tax warehouse on the condition that their **dispatch** is **electronically reported** to the customs authorities. The goods must be accompanied by documentation,

[27] Also referred to as the "Registered Trader". It is the status of the recipient of the excisable goods acquired from other EU member state. For more details you can look in the EU Horizontal Directive.

containing the **reference code** that allows the customs officers, if necessary, to track the goods. The warehousing and **transport** under such conditions are called the **suspension system.**

The taxation of excisable products is harmonised **within the EU** not only with regards to the rates. There is also a **common electronic system** controlling their movement. The products can be delivered from one member state to another member state in the suspension system and the excise duty is paid only when the goods are released to the free circulation in the member state of consumption. Goods that were released into free circulation in a member state and subsequently dispatched to another member state also have to be reported in an electronic system. The supplier can ask for a **refund of the excise duty** paid in respect of such goods in the state of origin if s/he submits evidence that s/he had paid the excise duty in that state and the recipient had paid the excise duty in the state of destination of the goods. There are also specific rules for distance selling of the excisable products but they would exceed the scope of this chapter.

Exemption from excise duties

Certain products are **exempt from excise duties**. An exemption is usually applied to products that are not used for detrimental purposes, meaning harmful to health or the environment. The other purpose of the exemption is the fact that taxation of such products would hurt certain important industries and subsequently adversely impact employment, etc. There is also an exemption for **purchases by individuals from abroad** that do not exceed certain limits (e.g. 10 L of spirits, 110 L of beer, and 90 L of wine from which 60 L can be sparkling, etc.). In addition, traditional exemptions in the context of **diplomatic** relations, **international organisations,** and NATO forces are in place.

Furthermore, examples of exemption from excise duties can be named certain mineral oils used otherwise than as propellants or for heating, ethyl alcohol used for the **production of pharmaceuticals** or foodstuffs, small-scale production of beer and wine for personal use, etc. The general exemption also applies to products that are taken away by the customs authorities as **samples** for various tests.

Discussion questions:

1. Do you think excise duties get threatened by tax evasion?
2. Why do you think the minimum excise duty rate, as specified by the Alcohol Directive, is zero for wine but non-zero for beer?

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