What **taxes** are about after public finance reform

The Act on Stabilizing Public Budgets was published Oct. 16, 2007, in the Collection of Laws of the Czech Republic. The act, prepared by the Cabinet of Prime Minister Mirek Topolánek (Civic Democrat, ODS), brought about the long awaited and discussed reform of public finance.

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The reform of public finance covers taxes, social systems (including social welfare systems, sickness insurance, salaries and employment policy), public health insurance and public health insurance companies.

However, many foreigners who are university educated are struggling to find work that corresponds to their level of education and background according to a survey by the Sociological Institute of the Academy of Sciences and the Ministry of Labor and Social Affairs.

According to the legislators, the reform should mainly optimize and regulate the revenues and expenses of the state budget, positively influence the state deficit and, by reducing the personal and corporate tax burden, boost overall economic growth. The results of these goals are envisaged in the long-term horizon. The immediate impacts of the reform on each natural or legal person can be seen, however, during the first days of its effect.

Income Taxes Act

With respect to the amendments to the Income Taxes Act (Act No. 586/1992 Coll.), the media's attention has focused mainly on the substitution of the progressive taxation of individuals by a unified tax rate of 15 percent (12.5 percent in 2009), substantial increases in the amounts of personal tax relief and the introduction of the "supergross wage."

The supergross wage is determined based on an employee's gross wage—a wage not reduced by the employee's portion of social security and health insurance contributions—increased by the employer's portion of social security and health insurance contributions.

Altogether, the implementation of a relatively low unified tax rate of 15 percent and quite generous tax relief substantially reduces the overall tax burden of individuals. The introduction of the supergross wage—and accordingly the abolishment of the possibility of self-employed persons to deduct their social security and health insurance contributions from their taxable income—completely overhauls the determination of an individual's tax base. The final effect is not so rosy.

The new concept of the supergross wage largely eliminates the positive trend in the reduction of an individual's tax burden by actually increasing the effective tax rate to 20.25 percent. This is 15 percent of the gross wage increased by the employer's portion of the social security and health insurance, or 15 percent of 135.

Moreover, the scope of employment income subject to social security and health insurance has been extended and includes among other things an employee's nonmonetary income in the form of using a company car both for business and private purposes. The corresponding employment income is calculated as 1 percent of the purchase price of the respective car per month.

Even though not discussed as much by the public, the reform implements the long awaited social security and health insurance cap on income from dependent (employment) activities. However, at 48 times the average annual wage (for 2008 the cap is Kč 1,034,880), the cap will only directly affect high-income groups.

Corporations are expected to profit especially from reductions in the corporate income tax rate, which remains on a downward trend and will drop gradually from 21 percent in 2008 to 20 percent in 2009 and 19 percent in 2010.

It remains questionable whether the decreasing corporate income tax rate actually brings about the promised effect, as it will be partially compensated by tightened conditions for the tax deductibility of certain costs and expenses. These tightened conditions similarly apply to self-employed persons, which likewise lead to an increase of their tax base.

Among other things, the extension of the lease period necessary to meet the conditions of the tax deductibility of the lease payments for financial leasing will negatively influence the everyday life of a wide number of taxpayers.

Taxpayers will further have to cope with the strengthened rules of thin capitalization.

Generally, thin capitalization rules (the thin capitalization test) set limits on the tax deductibility of interest paid on credits and loans. Until 2007, these rules applied only to loans and credits whose creditor was a person related to the debtor, whereas interest payments on the amount by which the sum of credits and loans in a taxable period exceeded four times the equity of the debtor (six times for banks and insurance companies) were considered as tax nondeductible.

From Jan. 1, 2008, not only interest paid on credits and loans, but also the related financial costs/expenses (for example, to secure credit, or the costs of credit processing) are subject to the thin capitalization test as well.

Moreover, thin capitalization rules now additionally apply to unrelated parties. As a result, all loans and credits, including common bank credits, can be subject to thin capitalization. In these cases, the criterion is stipulated as six times a debtor's equity (from Jan. 1, 2009, four times).

The criterion for related parties is reduced to two times (for banks and insurance companies three times) of a debtor's equity, and also applies to loans and credits secured by a person related to the debtor.

In addition, financial costs and expenses for loans (credits) subordinate to other liabilities and loans (credits) whose interest is derived from company results are considered tax nondeductible.

Last but not least, the reform amended the thin capitalization rules to include an additional general limit on the tax deductibility of financial costs/expenses—applicable to both related and unrelated parties—stated as a multiple of the unified interest rate increased by 4 percentage points and the average balance of credits and loans in the course of a taxable period (the period for which the tax return is filed). The unified interest rate is determined as the average of a reference value of interest rates on the interbank deposits' market for maturity of 12 months as at the last day of each month of the tax (the period for which the tax return is filed).

The thin capitalization test does not apply mainly to financial costs/expenses related to loans and credits between unrelated parties not exceeding Kč 1 million in the respective tax period, individuals and interest free loans and credits.

Foreign investors in particular welcomed the implementation of the new corporate tax exemptions applied in the relationships between parent companies and their subsidiaries. Under the conditions stipulated by the legislation, the tax exemption of dividends was extended to dividends paid by subsidiaries with their registered office in a non-EU member state that has concluded a double taxation treaty with the Czech Republic. Under analogous conditions to dividends, the corporate tax exemption was also extended to the income of a parent company—a tax resident in the Czech Republic or the permanent establishment of a Czech tax nonresident—from the sale of a share in the subsidiary.

Value-Added Tax Act

Even though desired mainly with regard to questionable provisions related to intracommunity trade, the reform of public finance has not brought about many fundamental amendments to the Value-Added Tax Act (Act No.235/2004 Coll.) and was limited to a few specific changes.

The most important changes concern the increase in the reduced value-added tax (VAT) rate from 5 percent to 9 percent and the well-known and repeatedly discussed issue of social housing.

Even though not so much debated in public, the reform brings another important change—the possibility of group registration for VAT. This procedure is available in many EU countries, and its main purpose is to reduce the administrative burden related to the VAT compliance process in the case of related companies. In a simplified way, group registration allows a group of related persons to register and be treated as a single VAT payer, while transactions within the group are treated similarly to intracompany transactions, that is, no VAT is applied. Taking advantage of group registration can clearly lead to a reduction in the everyday administrative burden of the whole group and in certain cases may even decrease the total VAT burden of the group. On the other hand it is important to mention that group members are jointly and severally liable for all the VAT obligations of the whole group, which may be seen as its biggest disadvantage.

A positive amendment is the newly implemented possibility to ask the Ministry of Finance to issue a decision on a binding ruling on the correct classification of a taxable supply with respect to the standard or reduced tax rate. The practical impacts of this provision will be seen by time.

Environmental taxes

In compliance with the conditions of the Czech Republic's accession to the European Union, and the related transposition of Council Directive 2003/96/EC, new indirect environmental taxes on natural gas and selected other gases, solid fuels and electricity were introduced Jan. 1, 2008. Even though not fully comparable with excise duties, the basic principles of environmental taxes are similar and are generally included in the consumer price of the respective commodities, thus increasing them.

Inheritance and gift tax

In inheritance and gift tax, the government partially followed the earlier ODS proposals to abolish transfer taxes. However, instead of completely abolishing transfer taxes the reform was only limited to extending the inheritance tax exemption and implementing a gift tax exemption on property transfers between relatives.

From the beginning, tax reform as part of government public finance reform was presented as a vital change to the tax system that should result, mainly by means of the reduced tax burden, in economic growth. Time will show whether these expectations were well-founded. However, as things stand we can state that the expected and emphasized effect of reduced direct tax rates is significantly eliminated by the increase in the reduced VAT rate and many system changes to direct taxes the effect of which is contrary to the reduction of the total tax burden.

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