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## **Income Taxation of Entrepreneurs in the Czech Republic**

### **ABSTRACT**

This text deals with income taxation of entrepreneurs in the Czech Republic. It concerns construction of the tax and especially the tax base and compare taxation of employees and self-employed persons. The lump sum expenses are analyzed. Author tries to confirm or disprove the hypothesis that lump sum expenses are useful for both state (easy and cheap tax administration) and self-employed persons (lower taxation and easier evidence). The aim of this article is to decide, if lump sum expenses are useful for state and its tax revenue and if there is any need (and eventually how) to amend legal regulation of the personal income tax base. At the end author suggests several ways for the regulation *de lege lata*, like an obligation to issue tax bills, lowering the lump sum expenses rates, differentiation of lump sum expenses according to the types of incomes, connection with VAT payers regulation, and limitation of Svarcsystem.



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## **Opodatkowanie dochodów przedsiębiorców w Republice Czeskiej**

### **STRESZCZENIE**

Artykuł przedstawia kwestie opodatkowania dochodów przedsiębiorców w Republice Czeskiej. Dotyczy w szczególności konstrukcji podstawy opodatkowania oraz porównania opodatkowania pracowników i osób prowadzących działalność gospodarczą na własny rachunek. Analizie poddana jest konstrukcja kosztów podatkowych. Autor stawia tezę, że koszty ryczałtowe są korzystne zarówno dla państwa (prosta i tania administracja podatkowa), jak i osób prowadzących działalność gospodarczą na własny rachunek (niższe opodatkowanie i łatwiejsze prowadzenie ewidencji dla celów podatkowych).

Celem artykułu jest próba odpowiedzi na pytanie, czy konstrukcja kosztów ryczałtowych jest przydatna dla państwa i jego dochodów, a jeśli tak, to czy istnieje (i w jakim ewentualnie zakresie) konieczność zmiany przepisów dotyczących podstawy opodatkowania w podatku dochodowym od osób fizycznych. Autor sugeruje kilka sposobów regulacji *de lege lata*, jak np. obowiązek wystawiania rachunków podatkowych, obniżenie stawek kosztów ryczałtowych, zróżnicowanie kosztów ryczałtowych względem rodzajów dochodów, połączenie z przepisami dotyczącymi płatników podatku VAT i ograniczenie „systemu Svarca”.



## 1

## INTRODUCTION

There are many problems those entrepreneurs must face not only in the Czech Republic. And ones of the most important issues are taxes. There are many discussions on VAT, especially on tax rates (basic and reduced tax rate or just one rate, amount of rate(s) etc.), on excise taxes (tax rates and exemptions), on real-estate tax (ad valorem tax base, possibilities of municipalities to influence the revenue), on corporate incomes tax (tax rate, dividends paid in one year deductible from tax on the following year). But the most discussed topic and from my point of view the most important issue is personal income tax. Of course we will always deal with the optimal tax rate, but we must not forget that the tax rate is only one of many structural components and the tax burden and the revenue is influenced by the tax base and exemptions, too.

In this text I would like to point out the income tax paid by entrepreneurs in the Czech Republic, deal with the construction of the tax and especially the tax base, and compare taxation of employees and self-employed persons. The second group has a possibility to use so called lump sum expenses. I will try to confirm or disprove the hypothesis that lump sum expenses are useful for both state (easy and cheap tax administration) and self-employed persons (lower taxation and easier evidence). The aim of this article is to decide, if lump sum expenses are useful for state and its tax revenue and if there is any need (and eventually how) to amend legal regulation of the personal income tax base.

At the beginning it will be necessary to describe legal regulation in this area *de lege lata* including amendments valid from January 1, 2013. Later I will try to define strengths and weaknesses of up-to-date regulation and I will demonstrate status quo on the examples. At the end I will try to draft proposals *de lege ferenda*. I have read a lot of especially newspaper and online articles and opinions and dealt with this topic in my previous research<sup>1</sup>,

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<sup>1</sup> M. Radvan, *Lump Sum Expenses and Their Impact on Public Budgets in the Czech Republic* (in: *Бюджетные и налоговые реформы в странах Центральной и Восточной Европы*, Voronezh 2011, pp. 37–42.

but there is no adequate scientific literature in this area available in the Czech Republic<sup>2</sup>.

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## 2

### TYPES OF INCOMES AND PARTIAL TAX BASES

In the Czech Republic, the personal income tax is regulated together with the corporate income tax by an act called Income Taxes Act (Act no. 586/1992 Sb., as amended)<sup>3</sup>. This Act lies down that the objects of taxation are the following types of income (no matter if it is a monetary or a non-monetary income or the income was acquired by exchange):

- Income from dependent activity (employment) and emoluments of office-holders (function benefits);
- Income from business and from other independent gainful activity;
- Capital property income;
- Rental (lease) income;
- Other income.

Each of these incomes are described individually in Sections 6–10 of the Income Taxes Act and for each of these incomes it is necessary to calculate so called partial tax base and at the end every taxpayer must calculate these partial tax bases together to get the tax base.

#### 2.1. Incomes from Dependent Activities and Function Benefits

Even incomes from dependent activities and function benefits does not seem to be the issue for this text, it is necessary to mention that, because

<sup>2</sup> With the exemption of R. Boháč, *Paušální uplatňování daňových výdajů jako nástroj řešení hospodářské krize* (in:) Z. Papoušková et al., *Finanční věda a finanční právo v prostředí hospodářské krize*, Olomouc 2010.

<sup>3</sup> Vide for example I. Pařízková, M. Radvan (in:) M. Radvan et al., *Finanční právo a finanční správa – Berní právo*, Brno 2008; H. Marková, *Zákon o daních z příjmů – komentář*, Praha 2007; P. Mrkývka, *Opodatkowanie dochodu w Republice Czeskiej* (in:) L. Etel (ed.), *Opodatkowanie dochodu w wybranych krajach Europy Środkowej i Wschodniej*, Białystok 2006, pp. 93–128.

many persons actually employed (working dependently for the employee) are taxing their incomes like entrepreneurs (self-employed persons); they are officially self-employed, while it is more efficient for them. That is why it is important to define incomes from dependent activities (employment) and emoluments of office-holders (function benefits). Incomes for dependent activity are primarily incomes from the recent or former labor relationship, service relationship or membership relationship or a similar relationship if the taxpayer – employee – must respect the payor’s – employer’s – commands in the course of execution of work for the payor. Function benefits are mostly function salaries of members of the government, deputies and senators of the Parliament of the Czech Republic and salaries of judges, chiefs of central authorities of the state administration and remunerations for execution of function in authorities of municipalities, in other authorities of territorial self-governance, state authorities, civic and professional associations, chambers and other authorities and institutions. The most important of the definition for the purpose of this article is that employee must respect the employer’s commands in the course of execution of work for the payor.

**Partial tax base** from incomes from dependent activities and function benefits is constructed very specifically in the comparison with other EU member states as income from dependent activity or function benefits increased by sums of social security insurance premium, contribution to the state employment policy and general health insurance premium that must be paid by the employer according to special regulations<sup>4</sup>. The “social security” paid by employer is very high – 34% of the gross income.

## 2.2. Incomes from Business Activities

Incomes from business activities are incomes from agriculture production, forestry and fish farming, income from business (trade), shares of partners in profits of a general partnership and general partners’ shares in profits of a limited partnership. Incomes from other independent profitable activities such as the income from the use or provision of industrial or other intellec-

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<sup>4</sup> Till the end of 2007 the tax base was defined as income from dependent activity or function benefits **reduced** by sums of social security insurance premium, contribution to the state employment policy and general health insurance premium that must be paid by the employee according to special act. The “social security” paid by employee was **12,5%** of the gross income.

tual property and from copyright, income from pursuit of an independent profession, income of an expert, an interpreter, an arbitrator, income from activity carried out by a bankruptcy trustee, etc. are ranked between incomes from business activity.

For the purpose of this text I have to repeat that business activity is systematic and independent activity of the entrepreneur on his own name, on his responsibility to reach profit<sup>5</sup>.

**Partial tax base** from incomes from business activities is created by the above mentioned incomes reduced by the expenses incurred to generate, assure and maintain income specified in Section 24 of the Income Tax Act. If the taxpayer does not have enough expenses, he may claim lump sum expenses:

- 80% of the income from agricultural production, forestry and fish farming and from handicraft industry;
- 60% of the income from other industry and trades;
- 40% of the income from other business (for example lawyers, doctors, etc.) and other incomes like incomes from intellectual property, etc.;
- 30% of the income from rents of business property.

As the lump sum expenses were overused and sometimes even misused, the Parliament adopted the amendment valid from January 1, 2013. According to these new rules, lump sum expenses can be used only if the maximum value of lump sum expenses does not exceed:

- 800.000 CZK in case of incomes from other business and other incomes like incomes from intellectual property, etc.;
- 600.000 CZK in case of incomes from rents of business property.

There are no such a limits for incomes from agricultural production, forestry and fish farming and from handicraft industry and for incomes from other industry and trades.

Lumps sum expenses, if used, include all the expenses of the taxpayer. In this case the taxpayer must keep an evidence of all his incomes. There is not a word on the evidence of expenditures, but in my opinion it must be kept as well because of the duty set in Section 7a of the Income Tax Act or in the Accounting Act.

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<sup>5</sup> See Section 2/2 Business Code (Act no. 513/1991 Sb., as amended).

## 3

## BENEFITS AND MAIN PROBLEMS OF *DE LEGE LATA* REGULATION

There is no discussion that the lump sum expenses are very useful for the taxpayers. In case of tax control, the tax office controls mostly the incomes, not the expenditures and whether the expenses were spent to generate, assure and maintain income. More over, using the lump sum expenses, the tax burden will be probably lower. From the view of the state, the tax administration is easier and cheaper if the lump sum expenses are used by the taxpayer.

The main problem of lump sum expenses is connected with their rate. At the beginning of the efficiency of the Income Tax Act (taxable period 1993) **the rate of lump sum expenses** was relatively low:

**Table 1.** Lump Sum Expenses Rates

Type of Income	by 2004	2005–2008	2009	2010	2011–nowadays
Income from agricultural production, forestry and fish farming	50%	80%	80%	80%	80%
Income from handicraft industry	25%	60%	80%	80%	80%
Income from other industry and trades	25%	40%	60%	40%	60%
Income from other business	25%	40%	60%	40%	40%
Incomes from intellectual property	30%	40%	60%	40%	40%
Other incomes	25%	40%	60%	40%	40%
Rental Incomes	20%	30%	30%	30%	30%

Source: R. Boháč, *Paušální uplatňování daňových výdajů jako nástroj řešení hospodářské krize* (in: Z. Papoušková, et al., *Finanční věda a finanční právo v prostředí hospodářské krize*, Olomouc 2010, p. 142.

At the explanatory report to the Income Tax Act we can read that the main purposes of the lump sum expenses are practical aspects and administrative

simplification, not the tax relief.<sup>6</sup> May be it could be right by the taxable period of 2004, but later the lump sum expenses have started to be more political than economic question and nowadays it is real tax relief for many taxpayers. For example me as author of the textbook: I have no real expenses, but I have to tax only 60% of my income. Of course we can mention here many similar cases, where real expenses are far from the lump sum expenses.

### **Different rates of lump sum expenses for different types of incomes**

I find as a problem, too. Let's have a look at two handicraft industries: mason and in-keeper. Mason usually has almost no real expenses; he is coming to the working place, where building material is prepared, bought by the investor. He needs just bricklayer tools (not very expensive and possible to use for a long time), working clothes, may be he is coming by car... What else? On the other hand in-keeper is paying rent, must buy all the products he is selling, etc.; his margin is usually at about 20%. It means that in case of in-keeper the lump sum expenses are set correctly, but the mason can save a lot of money while his tax is unfairly low. And we can give here many similar examples like car mechanics, chimney sweepers, plumbers, etc.

The benefits of lump sum expenses are causing in other problem, in the Czech Republic known as **Svarc**system. Mr. Svarc as a businessman was signing up employees, but even if they had to respect the Mr. Svarc's commands in the course of execution of work for him, officially they were self-employed. This practice has never disappeared from the Czech economy, more over thanks to the advantages of lump sum expenses it is more often nowadays. This system offers even more benefits: the "employer" has no duty to pay social and health insurance for his "employees" and they are cheaper than real employees. The "employee" can pay lower taxes and social insurance, so he has no reason to fight with his "employer" for legal status.

I will try to demonstrate the tax impact on the example of mason with one child, with a gross wage of 300.000 CZK (approximately 12.000 EUR) per year:

<sup>6</sup> R. Boháč, *Paušální uplatňování daňových výdajů jako nástroj řešení hospodářské krize* (in: Z. Papoušková, et al., *Finanční věda a finanční právo v prostředí hospodářské krize*, Olomouc 2010, p. 142.

**A) Employed mason**

Gross wage	300.000
+ Soc. and health ins. (34% of gross wage)	102.000
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Tax base	402.000
– Tax allowances	– 0
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Modified tax base (rounded down)	402.000
Tax <i>brutto</i> I (15% of the tax base)	60.300
– Tax reductions	– 24.840
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Tax <i>brutto</i> II $\geq 0$	35.460
– Tax preferences for one child	– 13.404
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<b>Tax <i>netto</i></b>	<b>22.056</b>

**B) Self-employed mason**

Gross income	300.000
– Lump sum expenses (80% of gross income)	– 240.000
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Tax base	80.000
– Tax allowances	– 0
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Modified tax base (rounded down)	80.000
Tax <i>brutto</i> I (15% of the tax base)	12.000
– Tax reductions	– 24.840
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Tax <i>brutto</i> II $\geq 0$	0
– Tax preferences for one child	– 13.404
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<b>Tax bonus</b>	<b>13.404</b>

So called tax allowances are modifying (reducing) the tax base. The most common tax allowance is the value of gifts donated for charitable purpose in case that the total value of gifts in the taxable periods does not exceed

2% of the tax base or 1.000 CZK and the total maximum allowable deduction is 10% of the tax base. Other tax allowances are offered to the taxpayers paying contributions to the state-contributory supplementary pension insurance scheme (sum paid within the taxable period reduced by 12.000 CZK; the maximum amount is 12.000 CZK in one taxable period) or paying private life insurance premiums (sum paid within the taxable period; the maximum amount is 12.000 CZK in one taxable period). As a tax allowances are considered the amount equal to the interest paid in the taxable period on a loan provided from a housing saving scheme or the amount equal to the interest on a mortgage loan or the amount equal to the interest on a loan provided by a housing savings bank. The contributions paid by a member of a trade union organization up to 1,5% of the taxable income (the maximum amount is 3.000 CZK in one taxable period) and remunerations for exams verifying the result of continuing education up to 10.000 CZK are the last tax allowances according to Czech law.

Besides tax allowances, the taxpayer can use items deductible from the tax base to reduce his tax base, too. The most important item deductible from the tax base is a tax loss which was recorded and assessed in five previous taxable periods. There is one other important deductible item: 100% of costs for research and development.

The tax rate is percentual linear of 15% calculated from the reduced tax base.

The tax (gross tax) can be reduced by the tax reductions. The following amounts are valid per year:

- ☒ 24.840 CZK for each taxpayer with the exemption of pensioners (so called basic tax reduction);
- ☒ 24.840 CZK for a spouse living with the taxpayer in one household (but the spouse's own income may not exceed 68.000 CZK in the taxable period), if the spouse is the holder of ZTP/P card, the amount is double;
- ☒ 2.520 CZK for the beneficiary of a disability pension (1st and 2nd grade of disability);
- ☒ 5.040 CZK for the beneficiary of a disability pension (3rd grade of disability);
- ☒ 16.140 CZK for the ZTP/P card holder (very handicapped person with a guide);
- ☒ 4.020 CZK for the student up to 26 years or Ph.D. student up to 28 years.

Other tax reductions can be used if the taxpayer employs disabled employees.

People with children living in their household have right to use so called tax preferences for children. For each child one parent can deduct as the tax reduction an amount of 13.404 CZK in a year. If the tax after this reduction would be in minus, the tax preference is divided into two parts: tax reduction up to zero tax and tax bonus. If the taxpayer is economically active, the tax bonus (up to 60.300 CZK) should be paid him back!

In fact, legal regulation *de lege lata* of self-employed persons is so soft that it offers many entrepreneurs not only not to pay taxes at all, but to “receive taxes from state” as they have right for tax bonus. Of course there are state institutions with the right to control the status of the employees and “employees” (bureaus of labor, financial offices, social security offices, health insurance houses), but it is quite difficult for them to find those black employees and prove illegal behavior. Where is no plaintiff, there is no judge, I am afraid.

The other reason for low income tax revenue by self-employed persons is the **(non)existence of a duty to issue tax bills**. There is no legal obligation to issue a tax bill, unless the customer asks for one. But who really needs a tax bill for tax reasons? Employed persons have no possibility to deduct their expenses while calculating the tax and self-employed persons are usually using lump sum expenses and that is why they do not ask for tax bills, too. This practice leads to illegal reduction of taxable incomes and in the end to lower tax revenue. And unfortunately I have to repeat the same as I mentioned above: where is no plaintiff, there is no judge.

The legislator believed that amendment of lump sum expenses regulation should change existing practice and limit the overuse of lump sum expenses. As it was mentioned above and as it is evident from the example, the amendment does not concern incomes from agricultural production, forestry and fish farming, industry and trades. Only in case of incomes from other business (like lawyers, doctors, etc.) and other incomes and from rents of business property **the total value of lump sum expenses is limited**. But there is no visible change in the regulation for the most of taxpayers, because usually the total income really does not exceed 2.000.000 CZK.

## 4

## CONCLUSION

In my opinion, the lump sum expenses have a lot of advantages, especially for the taxpayers. As we could see above, the main benefit is in tax duty that can be lower by tens of percent. The second advantage is in lower demands on tax optimization and thus saving money for tax advisory. For state it is not so easy to find the advantages, because the disadvantages prevail. Of course lump sum expenses mean easier and cheaper tax administration, but... We can see that public budgets are losing a lot of money in the system of over-limit lump sum expenses.

I believe the number of entrepreneurs using lump sum expenses should be limited. There are several ways:

1. An obligation to issue tax bills every time entrepreneur receives money for goods or services would lead to higher taxable incomes and higher expenditures shown in the accounting books;
2. The lump sum expenses should be lower in general and the maximum rate I can imagine to be effective for state is 50%;
3. There should be more differences between the types of incomes. There are many types of industries, but they all are defined and described in the appendix to The Trades Licensing Act<sup>7</sup>. There is no problem to use this;
4. The lump sum expenses should be used only by those who are not the VAT payers. The VAT payer has a duty to keep accounting books and the reason for lump sum expenses using (lower requirements for the bookkeeping) is limited;
5. Every taxpayer using lump sum expenses should have at least one employer. This would lead to the reduction of so called Svarcsystem (even to reduce Svarcsystem only we only need more precious control of respective authorities) and to higher rate of employment.

All these above mentioned proposal would lead to more fair tax system, with no huge differences between the taxation of employed and self-employed persons (of course with the respect to their responsibility and risks),

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<sup>7</sup> Act no. 455/1990 Sb., as amended.

and bring more money to the public budgets. The hypothesis, that lump sum expenses are useful for both state and self-employed persons, was disproved: *de lege lata* it is useful only for self-employers, but *de lege ferenda* it could be useful for both groups those have anyway the same task: to pay taxes in time and according to law.

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