Assessment of Consistency of the Czech Tax Law with European Union Law with a View to Non-Residents Taxation

Hodnocení souladnosti českého daňového práva s právem Evropské unie se zaměřením na zdaňování nerezidentů

KAREL BRYCHTA

Abstract

This paper is focused on assessment of consistency of the present Czech legal regulation with the European Union Law with a view to taxation of tax non-residents from other EU Member States, above all with a view to incomes from dependent activity (employment) and function benefits and from enterprise activities and other self-employed gainful activities. The introduction of the paper presents attributes which the Czech regulation shall satisfy in order it could be considered as consistent with the European Union Law. These attributes are deduced from the relevant ECJ case law. Subsequently the reader is making acquainted with some aspect of legal regulation of taxation of Czech Republic tax non-residents. The attention is above all granted to the description and assessment of the impacts of changes connected with an amendment of the Act on Income Taxes which has implemented a new regime of taxation for some incomes of tax non-residents from EU or EEA Member States who are at the same time tax residents of some of these States. In conclusion it is to observe that this amendment has significantly contributed to an advance in reaching consistency of the Czech legal regulation with the European Union Law that has been represented in the area in question above all by the ECJ case law.

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Keywords

Czech act on income taxes, European Court of Justice, natural persons, non-resident, taxation

Abstrakt

Tento příspěvek se zaměřuje na zhodnocení souladnosti současné české právní úpravy zdaňování daňových nerezidentů z jiných členských států EU s právem Evropské unie a to zejména pro příjmy ze závislé činnosti a funkčních požitků a příjmy z podnikání a jiné samostatně výdělečné činnosti. V samotném úvodu jsou prezentovány atributy, které by

měla tuzemská úprava splňovat, aby bylo možné ji považovat za souladnou s právem Evropské unie. Uvedené atributy jsou odvozeny od směrodatné judikatury ESD. Následně jsou v základních rysech přiblíženy vybrané aspekty zdaňování daňových nerezidentů České republiky. Největší pozornost je věnována popisu a zhodnocení dopadů změn v souvislosti s novelou zákona o daních příjmů, kterou byl implementován nový režim zdaňování některých příjmů daňových nerezidentů z členských států EU a států EHP, kteří jsou zároveň daňovými rezidenty některého z těchto států. Závěrem lze konstatovat, že tato novela významně přispěla k dosažení větší souladnosti české právní úpravy s právem Evropské unie, které je v předmětné oblasti prezentováno především judikaturou ESD.

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Klíčová slova
český zákon o daních z příjmů, Evropský soudní dvůr, fyzické osoby, nerezident, zdaňování

JEL classification
H24, H25, K34, P29

Introduction

Act No. 586/1992 Coll., on Income Taxes, as amended (hereinafter referred to as AIT) is the basic material-law standard regulating the taxation of tax non-residents in the Czech Republic. This act became effective on 01 January 1993 along with the foundation of the independent Czech Republic (hereinafter referred to as CR). Since AIT became effective, it has undergone a number of larger or smaller changes which also dealt with the issue of taxation of incomes of tax non-residents from sources in the CR.

The issues of taxation of tax non-residents are affected significantly also by the Conventions for Avoidance of Double Taxation (hereinafter referred to as CADT), the aim of which is to remove or eliminate international double taxation. The Czech Republic has currently over 70 such contracts concluded (Ministerstvo financí ČR, 2009) [Ministry of Finance CR]. In this connection it is useful to mention that the Czech Republic has concluded CADT with all Member States of the European Union (hereinafter referred to as EU). The application priority of CADT as international conventions does not only arise from AIT (Section 37), but directly from the supreme legal force standard, namely from Article 10 of Constitutional Act No. 1/1993 Coll., Constitution of the Czech Republic, as amended. In this respect there is a question of the compliance of these conventions with the Community Law (at present with the European Union Law)[1], which is another basic source of law in the Czech Republic. This issue was dealt with by a group of experts who have come to a conclusion that the situation in this respect is quite complicated with regard to the large number of conventions, which actually represents

1 Since the European Union acquired legal personality by becoming the Lisboan Treaty valid, we now speak of the European Union Law instead of the Community Law.

great obstructions and difficulties for taxpayers when fulfilling their basic freedoms arising from the Treaty Establishing the European Community[2] (European Commission, 2005).

The field of regulating direct taxes is, in particular, an expression of the sovereignty of individual Member States which have retained a larger rate of autonomy in this field. This, however, does not mean that the regulation in this area may be arbitrary. It is beyond any doubts that despite of the missing explicit regulation of taxation of incomes of natural persons adopted at the level of the European Community (now at the level of the European Union), to which, for example, Meussen refers (2004, p. 158), it is necessary to emend also this field in a certain way. The decisive role in this respect is played by the European Court of Justice (hereinafter referred to as ECJ), which plays the role of the so-called indirect harmonization (Široký, 2009, p. 27). The ECJ is an authority which ensures that when interpreting and applying the Treaty[3], which in the Czech Republic as a Member State has priority to the national regulation, is observed.

The aim of this paper is to assess the compliance of the Czech current regulation (according to the state valid and operative as of 01 December 2009) in taxation of tax non-residents from other EU Member States with a view to natural person and, in particular to incomes from dependent activity (employment) and function befits (Section 6 of AIT) and to incomes from enterprise and other self-employed gainful activities (Section 7 of AIT). Special attention is paid to an important amendment which substantially modifies the system of taxation of incomes acquired by tax non-residents from EU and having their source in the Czech Republic (Act No. 216/2009 Coll.).

The article has the following structure. The next chapter presents attributes which the Czech regulation shall satisfy in order it could be considered as consistent with the European Union Law. These attributes are deduced from the decisive ECJ case law represented by chosen ECJ rulings. The next chapter describes the system of taxation of tax non-residents in the CR. Then the readers are acquainted with the relevant provisions of Act No. 216/2009 Coll., which have significantly corrected the system of taxation of the selected types of incomes gained from sources in the CR by tax residents of other Member States of the European Union (EU) and of the States of the European Economic Area (hereinafter referred to as EEA[4]). The impact of changes introduced by the above-mentioned amendment of AIT is presented on a model example for the mentioned group of taxpayers. The final chapter assesses the compliance of the current Czech legal regulation with the European Union Law or more precisely with the selected ECJ case law, which is, due to

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2 *Since the Lisbon Treaty became valid on 01 December 2009 the Treaty establishing the European Community becomes the Treaty on the Functioning of the European Union. Note: * Due to the fact that on the date of finishing this paper there was not available consolidated version of the Treaty on European Union and Treaty on Functioning of the European Union as amended by the latest version of the Lisbon Treaty, a version available in the Official Journal of the European Union 2008/C 115 was used.*

3 *It used to be regulated by Article 220 et seq. of the Treaty establishing the European Community; since becoming the Lisbon Treaty effective the functioning and role of the ECJ is newly regulated by Article 19 of the Treaty on the European Union.*

4 *The EEA includes, on top of the European Union Member States, also Iceland, Liechtenstein and Norway.*

an absence of a binding legal regulation at the level of the European Union, a standard guideline for the issue in question.

1 Attributes of Consistency with European Union Law

At the very beginning we start with the definition of tax residents and non-residents according to AIT. As to the natural persons is concerned, the definition is provided in the Section 2 of AIT. Tax non-residents (in the words of AIT: a person having a tax liability related only to incomes from sources in the territory of the Czech Republic) are those whose permanent residence is not in the CR and who usually do not stay in the CR or those specified so by an international convention. The latter has a relation particularly to the existing CADTs and their Article 4 designated as Resident or in older conventions as Tax domicile. This article of the CADT determines the basic general criteria of tax residence[5], but also it prevents that a taxpayer is regarded as a tax resident in both respective contracting States. If such a situation happened and according to both national regulations the taxpayer was regarded as a tax resident, owing to the application of criteria set as a standard in Article 4 of the respective CADT, only one of the States will be determined as the State of tax residence while in the other State the taxpayer's status will be the status of tax non-resident.

Apart from that, Section 2 paragraph 3 of AIT contains a special regime of tax non-residence. It is a natural exception, or better to say exceptions. If a taxpayer only stays in the Czech Republic for the purpose of a study or treatment, he is regarded as a tax non-resident and his tax liability relates only to incomes from sources in the CR. Individual criteria are detailed in both Section 2 of the AIT and the Instruction D-300 for the uniform procedure in applying some provisions of the AIT.

The European Union Law in this respect, i. e. in setting of tax residency criteria, plays no role so that there is given a discretion for the Member States limited by the general criteria stated in relevant concluded CADT. On the contrary the European Union Law is affecting other aspects relating taxation of tax non-residents in case they are at the same time nationals of, and reside in, an EU Member State.

1.1 ECJ Case Law

Since 1 May 2004, the Czech Republic has been a Member of the European Union, which is built on a certain policy the aim of which is the actual realization of four basic freedoms – a free movement of goods, people, services, and capital. This fact takes effect substantially in the requirements placed on legislative regulations not only at the level of the European Union (previously European Community), but also it affects directly national legislations of the Member States because by their accession the Member States committed themselves to adhere to acquis communautaire. Even if there are no directly explicit provisions affecting the regulation of approach of the Member States to tax non-residents from other

5 It usually covers criteria such as place of residence, permanent stay, a place of management, or any other similar criterion. Further specifications (concretizations) of the criteria are given by domestic regulation of the contractual States (i. e. States which concluded the CADT).

Member States in the area of taxation of incomes from dependent activity (employment) and function benefits and from enterprise and other self-employed gainful activities, it does not mean that this area is not affected by the European Union Law. The proof of this is a number of judgments of the ECJ which deal with the area in question. Some rulings of the ECJ in relation to the area in question are stated below.

1.1.1 Case Schumacker

In the case Schumacker (Case C-279/93) the ECJ has observed that, *"Although direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law. Accordingly, Article 48[6] of the Treaty must be interpreted as being capable of limiting the right of a Member State to lay down conditions concerning the liability to taxation of a national of another Member State and the manner in which tax is to be levied on the income received by him within its territory, since that article does not allow a Member State, as regards the collection of direct taxes, to treat a national of another Member State employed in the territory of the first State in the exercise of his right of freedom of movement less favourably than one of its own nationals in the same situation.".*

The ECJ has further more observed that, *"Although Article 48 of the Treaty does not in principle preclude the application of rules of a Member State under which a non-resident working as an employed person in that Member State is taxed more heavily on his income than a resident in the same employment, the position is different in a case where the non-resident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances. There is no objective difference between the situations of such a non-resident and a resident engaged in comparable employment such as to justify different treatment as regards the taking into account for taxation purposes of the taxpayer' s personal and family circumstances. It follows that Article 48 of the Treaty must be interpreted as precluding the application of rules of a Member State under which a worker who is a national of, and resides in, another Member State and is employed in the first State is taxed more heavily than a worker who resides in the first State and performs the same work there when the national of the second State obtains his income entirely or almost exclusively from the work performed in the first State and does not receive in the second State sufficient income to be subject to taxation there in a manner enabling his personal and family circumstances to be taken into account.".*

The ECJ has concluded that, *"Article 48 of the Treaty must be interpreted as precluding legislation of a Member State on direct taxation under which the benefit of procedures such as annual adjustment of deductions at source in respect of wages tax and the assessment by the administration of the tax payable on remuneration from employment is available only to residents, thereby excluding natural persons who have no permanent residence or usual abode on its territory but receive income there from employment.".*

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6 After amendment Article 39 of the Treaty establishing the European Community. Since becoming the Lisbon Treaty effective Article 45 of the Treaty on Functioning of the European Union is involved.

1.1.2 Case Gschwind

The case Gschwind (Case C-391/97) related also to the issue of tax reliefs in connection with Article 48 of the Treaty establishing European Community. In this case the ECJ ruled that, *"Article 48(2) of the Treaty (now, after amendment, Article 39(2) EC) is to be interpreted as not precluding the application of national legislation under which resident married couples are granted tax benefits while, in the case of non-resident couples, such benefits are subject to the condition that at least 90% of total income be subject to tax in that Member State, failing which, if that percentage is not reached, income from foreign sources and not subject to tax in that State must not exceed a certain ceiling, the possibility being thus maintained for account to be taken of the couple's personal and family circumstances in the State of residence. The fact that a Member State does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since, as regards direct taxation, those two categories of taxpayer are not in a comparable situation. Specifically, a non-resident married couple - one of whom works in the State of taxation in question and who may, owing to the existence of a sufficient tax base in the State of residence, have personal and family circumstances taken into account by its tax authorities - is not in a situation comparable to that of a resident married couple, even if one of the spouses works in another Member State.".*

1.1.3 Case Gerritse

The case Gerritse (Case C-234/01) related to the possibility to deduct business expenses. Hence, the ruling can also be considered as a very important one. The ECJ States in its ruling that, *"Article 59 of the Treaty (now, after amendment, Article 49 EC[7]) and Article 60 of the Treaty (now Article 50 EC[8]) preclude a national provision which, as a general rule, takes into account gross income when taxing non-residents, without deducting business expenses, whereas residents are taxed on their net income, after deduction of those expenses.".*

At the same time the ECJ has expressed to the issue of application of definitive tax at a uniform rate deducted at source as follows, *"Article 59 of the Treaty (now, after amendment, Article 49 EC) and Article 60 of the Treaty (now Article 50 EC) do not preclude a national provision which, as a general rule, subjects the income of non-residents to a definitive tax at the uniform rate of 25%, deducted at source, whilst the income of residents is taxed according to a progressive table including a tax-free allowance, provided that the rate of 25% is not higher than that which would actually be applied to the person concerned, in accordance with the progressive table, in respect of net income increased by an amount corresponding to the tax-free allowance.".*

1.2 Summary

The author thinks that with regards to the conclusions of the ECJ it can be summarized that the basis for reaching the compliance of domestic regulation with the European Un-

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7 *Article 56 of the Treaty on Functioning of the European Union.*

8 *Article 57 of the Treaty on Functioning of the European Union.*

ion Law (previously with the Community Law) with a view to the taxation of incomes[9] of Czech Republic tax non-resident from another EU Member States who is at the same time a national of, and resides in, another EU Member State includes, in general, two basic attributes:

1. To secure by law stated possibility for this group of taxpayers to deduct, in relation to the reached income, the relevant expenses provided that also the tax residents of the CR have this possibility (the opposite approach is, according to the author's opinion, in conflict with the basic supporting principle of the European Union, which is the principle of prohibition of discrimination), and
2. To enable this group of taxpayers from other Member States to apply, under adequate conditions, also tax reliefs (non-taxable parts of tax base, tax abatements and tax allowance) to which, as a standard, the tax residents of the CR are entitled.

Before carrying out of the assessment of the consistency of the Czech legal regulation for the tax area in question, there is presented a system of taxation of Czech non-residents according to AIT in the next chapter.

2 The system of tax collection from tax non-residents (natural persons)

The primary differences in the system of taxation of tax non-residents arise from whether he/she is a tax resident of a contracting or non-contracting State (i.e. the State with which the Czech Republic has or has not concluded CADT). Provided that it is a performance in favour of a contracting State's resident, the decisive criterion is the relevant provision of CADT. The relevant convention may set that only one State is entitled for taxation or, conversely, both States, i.e. the State of source (i.e. the CR) and the State of the taxpayer's tax residence. Before solving the method and amount of tax it is necessary to decide whether it is possible to tax a particular income in the CR according to the respective CADT. The following step should be an assessment whether it is an income from sources in the CR, i.e. whether it is an income listed in the enumerating list in Section 22 paragraph 1 of the AIT, according to which two basic categories of incomes can be identified. The first category represents incomes that are regarded as incomes of tax non-residents from sources in the CR regardless of from whom these incomes are gained (a classical example is incomes from activities performed in a permanent establishment, incomes from the sale and lease of real estate located in the CR). For this group of incomes it is not important whether they are gained from a tax resident or a tax non-resident in the Czech Republic or from a permanent establishment located in the Czech Republic. Conversely, incomes of non-residents from the other category are only regarded as incomes from sources in the Czech Republic provided that they are gained from tax residents of the Czech Republic or from permanent establishments of tax non-residents located in the Czech Republic (e.g. licence fees).

9 A necessary condition is that the income can be taxed in the territory of the Czech Republic according to relevant CADT and the same time it comes under incomes stated under Section 22 paragraph 1 of ITA (for more details see below).

Only if CADT enables to tax a particular income of a tax non-resident and at the same time it is an income from sources in the CR, it is possible to proceed to solving a particular tax liability and the form of its settlement. It is obvious that when solving the relationship to a tax non-resident of the Czech Republic from a non-contracting State, the first step, i.e. the assessment of the relevant provisions of CADT, is omitted.

In many respects, the legal regulation of taxation of incomes of tax non-residents is based on the decisive role of the payer – i.e. the entity that performs in favour of a tax non-resident. Basically, we can distinguish three methods of taxation of incomes of tax non-residents in the CR by which they are taxed:

- by a special tax rate (tax deducted at the source by the payer according to Section 36 of AIT),
- through a tax return with the possible previous securing of tax (the obligation to file a tax return of natural person incomes is regulated in Section 38g of the AIT, and the tax securing institute then in Section § 38e of the AIT),
- through withheld tax advances in the case of incomes from employment and function benefits (specified in Section 38h of the AIT).

Ad a) Taxation by a special tax rate

Taxation by a special tax rate is one of the frequently used institutes in relation to the tax liability of a taxpayer (tax non-resident) for incomes from sources in the CR. It is the payer's obligation – i.e. the entity that performs in favour of a tax non-resident – to withhold (deduct) and transfer withheld tax to tax administrator. In AIT, the withholding tax rate is currently uniform, except for one small exception, and it is 15%. The mentioned exception is the income from rent in the case of financial leasing with the subsequent purchase of the leased object for which the rate of 5% is set. However, the application preference of CADT must be followed as it may set a different rate. It will be applied only if the rate is lower than that stated in AIT. This fact is an expression of the principle that a taxpayer must not be subjected to a higher taxation than that stated in AIT. It must be noted that the tax rates stated in CADT are usually lower than those set in AIT. At this point the author notes that a taxpayer may make use of the advantages arising from the respective convention only if he/she is a resident of the respective contracting State and also he/she is the so-called real owner of income (i.e. he does not act only as an agent, etc.).

Basically, the withholding tax amount is calculated from gross income. The general rule is that by withholding this tax (i.e. the tax according to Section 36 of the AIT), the taxpayer's tax liability in relation to that income is assumed to be fulfilled. There are exceptions from this general rule, some of them were introduced in relation to tax non-residents in Act No. 216/2009 Coll. It implemented a new provision into Section 36 of AIT (namely its paragraph 7), which offers tax non-residents of the Czech Republic who are at the same time tax residents of some of the EU or EEA Member States a more advantageous tax regime (for this issue see a separate relating chapter).

Ad b) Taxation through a tax return with a possible previous securing of tax
From the view of the tax resident's obligation to file a tax return of natural person income, AIT does not distinguish between the taxpayer's tax status; it is based on uniformly stated conditions which are provided in Section 38g of the AIT. Under the conditions stated by law (see Section 38e of the AIT) the filing of a tax return is preceded by the securing of tax. The purpose of this institute is, as the name suggests, to secure the tax in relation to tax non-residents who usually do not have such close relations to the State of the source of the income. The obligation to secure tax is the obligation on the part of the income payer. The basic rate of tax securing is 10%. There are special tax rates for special cases. The rate of tax securing of 1% will be used for incomes from the sale of investment instruments and for incomes from payments of claims acquired by assignment. With regard to the above-mentioned focus of the contribution on the taxation of incomes of natural persons, it should be added that there is another tax securing rate, in the amount of the natural person income tax rate (i.e. in the amount according to Section 16 of the AIT), which is applied from the share in the tax base of the partner of a co-partnership or the general partner of a special limited partnership who is a natural person (tax non-resident of the CR).

However, a large number of incomes of tax non-residents are excluded from the securing of tax. They include the following types of incomes:

- Incomes of tax non-residents which are subject to a special tax rate (a logical provision, taxation has been made, but in a different form),
- Incomes from employment and function benefits, when the tax advance is withheld according to Section 38h of the AIT,
- Payments for goods or services made in a retail shop where the vendor is a tax non-resident,
- Payment of rent paid by natural persons for residential rooms used for living and related activities, and
- Payment in favour of tax residents of the EU or EEA Member States.

The obligation to secure tax is the obligation of the payer, i.e. the entity that performs in favour of a tax non-resident. As a standard, this amount acts as a tax advance, i.e. if a tax non-resident of the CR files a tax return, he will credit the withheld amount of tax securing against his tax liability. So it is the taxpayer's interest to file a tax return. The advantages of filing a tax return in this case are quite obvious for a number of cases as the tax securing is again made from the gross amount.

In the filed tax return, the taxpayer may apply the respective tax expenses according to AIT and at the same time he credits the amount of tax securing against the final tax liability. Besides, it must be added that in accordance with Section 35ba of the AIT, a tax non-resident may apply the basic tax relief, without fulfilling any condition, namely a tax abatement per taxpayer is concerned, which is CZK 24,840 for the year 2009.

Even if a tax non-resident does not fulfil his obligation to file a tax return (which, however, very often causes a breach of Section 38g of the AIT), Section 38e of the AIT solves also this situation. In such case the tax administrator is entitled to consider the withheld amount

of tax securing to be the fulfilled tax liability. However, the latter cannot be interpreted as a possibility not to file a tax return.

Ad c) Through withheld tax advances in the case of incomes from dependent activity (employment) and function benefits

There is a special regulation for this type of income, i.e. income from dependent activity (employment) and function benefits (see Section 6 of the AIT). The obligation to withhold tax advances is again the obligation on the part of the payer – i.e. in this case the employer. Within determining the amount of the withheld tax advances, the employer may take only two basic tax abatements in calculation – the tax abatement per taxpayer (Section 35ba paragraph 1 letter a) of the AIT) and the abatement per student (Section 35ba paragraph 1 letter f) of the AIT). In the case of the latter abatement, it is, however, necessary to fulfil what is set in AIT and for this issue related acts, i.e. the taxpayer is, briefly speaking, a student continuously preparing for the future occupation by a study or prescribed training.

2.1 Tax return and the possibility to optimize the tax burden of a tax non-resident (natural person)

In general, tax residents and tax non-residents are not quite equal in relation to the possibility of tax optimization, nor in one of the three basic means of optimization of the tax liability of natural persons, for which the author takes:

- non-taxable parts of tax base (Section 15 of the AIT),
- tax abatements (Section 35ba of the AIT), and
- tax allowance per child (Section 35c of the AIT).

Some of the above-mentioned means of optimization of the tax liability of a tax non-resident (natural person) may be applied under identical conditions existing for tax residents. The so-called abatement per taxpayer (Section 35ba paragraph 1 letter a) of the AIT) has a specific position as it may be applied by both tax residents and tax non-residents automatically, without fulfilling any other condition. To apply other tax abatements, tax allowance per child and non-taxable parts, fulfilling the conditions set by law is required, whether by tax residents or tax non-residents. In regulation of tax reliefs there is obvious the law-maker's intent to encourage some activities of taxpayers (gifts for a certain type of purpose; additional pension insurance, etc.), as well as to take the personal status of a taxpayer into account (abatement due to taxpayer's invalidity, due to the taxpayer's studies, etc.). These facts on which tax allowances are based must be of course proven in the manner set by law.

Nonetheless, in relation to tax non-residents, the permission of most of the abatements, a tax allowance per child and one non-taxable part of tax base is conditioned by a uniformly set condition which is that the sum of incomes of a tax non-resident from sources in the CR amounts at least 90% of all of his entire incomes. As a rule, the incomes from sources in the CR do not include those that are exempted or are subject to a special tax rate (tax deducted at source).

A summary of the relevant information is shown in the following two tables (Table 1 and Table 2) in which the symbol "✓" means that the application of the particular tax item is allowed to tax non-residents (natural persons) under the same conditions as to tax residents, while the symbol "90%" designates the situation when the application is bound by fulfilling the condition of "90% of incomes from sources in the CR".

Table 1: Non-taxable parts of tax base

Non-taxable part of tax base	Year 2009
Gifts	"✓"
Additional pension insurance	"✓"
Private life insurance	"✓"
Payments for examinations verifying further education	"✓"
Interest on building saving credit and mortgage credit	"90%"

Source: Own elaboration.

As regards non-taxable parts of tax base, it is evident at first sight that prevailing are items whose application possibility is the same for both tax residents and tax non-residents. But it must be taken into account that the condition of application is mostly bound to fulfilling of other conditions set by Czech Acts.

Table 2: Tax abatements and tax relief

Tax abatements and tax relief	Year 2009
Per taxpayer (basic abatement)	"✓"
Taxpayer is a student	"✓"
Per spouse whose income does not reach the amount set by AIT	"90%"
Taxpayer's invalidity	"90%"
Taxpayer is a ZTP-P* card holder	"90%"
Tax relief per child	"90%"

* Especially seriously disabled with accompaniment

Source: Own elaboration.

As regards tax abatements and tax allowance per children, the proportion is quite opposite. The prevailing part is made up of items the application of which is conditioned by reaching at least 90% of taxpayer's income from sources in the CR. In relation to the application of items designated with the specification "90%", it can be stated that their application is basically enabled to a taxpayer (who is a tax non-resident) only through a tax return, which arises from the wording of Section 38g paragraph 2 of the AIT, which sets that if a tax non-resident applies abatements to which the "90% rule" is applied and/or a tax allowance per child and/or non-taxable part of tax base in the form of interest on credit (see above), he/she may do so only in the form of a filed tax return. A relatively

specific situation is if a tax resident is a taxpayer gaining incomes from employment and function benefits. However, with regard to the extensiveness of this issue and the focus of this contribution, it is not dealt with here in details.

The above-mentioned conditions for the application of non-taxable parts of tax base, tax abatements and tax allowance per child have remained unchanged also after becoming of the Act No. 216/2009 Coll. effective. This act which substantially modifies the system of taxation of tax non-residents who are tax residents of the EU or EEA Member States can be considered as of great importance in relation to taxation of Czech Republic tax non-residents.

3 Act No. 216/2009 Coll.

Act No. 216/2009 Coll. became effective on 20 July 2009 and, as it arises from transitional and final provisions of this Act, it will be used for the first time for the tax period of the year 2009[10]. Due to this amendment, the regime of taxation of incomes of tax non-residents of the CR, which is subject to a deduction (withholding) of the tax at the source, is split into two basic variants depending on whether taxpayer is or is not a tax resident of the EU or EEA Member State. For the specified types of incomes, the taxpayer (tax resident of the EU or EEA Member State) has now the possibility to use a more favourable regime of taxation.

The payer's obligation to deduct and transfer (pay) the tax withheld (deducted) at the source to the tax administrator remains unchanged. However, the category of taxpayers specified above has now the possibility to use the provision of Section 36 paragraph 7 of the AIT, which sets the following: *"If taxpayers stated in Section 2, paragraph 3, and Section 17, paragraph 4, who are tax residents of a Member State of the European Union or other States that make up the European Economic Area, include incomes stated in Section 22, paragraph 1, letters c), f) or g), points 1, 2, 4, 5, 6 or 12 in their tax return, the withheld tax will be credited to their total tax liability relating to incomes from sources in the Czech Republic, for which they file a tax return in the Czech Republic. If the withheld tax or its part cannot be credited to their total tax liability because the taxpayer has a tax liability amounting to zero or if he has reported a tax loss and/or his total tax liability is lower than the withheld tax, a tax overpaid will occur in the amount of tax liability that cannot be credited. If the taxpayer does not include incomes stated in Section 22, paragraph. 1, letters c), f) or g), points 1, 2, 4, 5, 6 or 12 in the tax return until the end of the time-limit set by a special legal regulation, Section 38e paragraph 7 will be applied similarly.".*

Before analysing the provision, it must be pointed out to the importance of the last sentence which has been mentioned above in a little different connection. This provision must be interpreted in such a way that if a taxpayer does not file a tax return within the time-limit set by Act No. 337/1992 Coll., on the Administration of Taxes and Charges, as

10 *It must be noted that in the explanatory report to this Act there is paid no attention to changes in relation to the taxation of tax non-residents (tax residents of other Member States of the EU or EEA) – no reasons are given for the changes made. The attention of the authors of the explanatory report is focused on the new regime of tax amortization.*

amended, the withheld tax is regarded as a settled tax liability. Such a procedure of a tax non-resident would be, however, in conflict with his interests as within the filed tax return he/she may apply both the respective expenses and the basic tax abatement amounting to CZK 24,840.

For a better orientation, individual incomes listed in Section 36 paragraph 7 of the AIT, i.e. incomes for which the new regime has been introduced, are specified in the table below (Table 3). Along with them, the table shows whether it is a type I income (regarded as income of a tax non-resident regardless of from whom the tax non-resident gains the income) or a type II income (regarded as income of a tax non-resident of the CR only if gained from a tax resident of the CR or a permanent establishment in the CR). There is also specified a relevant Article of CADT because respective CADT is another relevant source of law affecting the way of the taxation of these incomes (see above).

A significant fact also in the case of this regime introduced by the Act No. 216/2009 Coll. is that the Czech Republic has concluded CADT with all Member States of the EU and EEA, except for Liechtenstein. This fact is apparent particularly in relation to incomes according to Section 22 paragraph 1 letter c) and letter f) point 1 of the AIT, as these incomes of tax non-residents from sources in the CR are generally subject to taxation only if a permanent establishment come into being here – not until the origination of a permanent establishment in the territory of the Czech Republic. However, the taxation of incomes of a permanent establishment is subject to a quite different taxation regime (see Section 22 paragraph 1 letter a) of the AIT) and its incomes naturally are not included in the list in Section 36 paragraph 7 of the AIT. So in this respect, i.e. in relation to given incomes, at first sight the existence of this regime may seem unnecessary. On the other hand, it must be taken into account that the above mentioned is an expression of the law-maker's carefulness in case a specific stipulation of a CADT deviates from this general regulation and also due to the fact that the CR has not concluded CADT with Liechtenstein.

The fact that the CR has concluded CADTs with all the Member States of the EU and with Iceland and Norway (as the States of the EEA) has an effect on the amount of the withholding tax rate which may be withheld by the respective payer. The CADT usually specifies the maximum tax rate for certain types of incomes (e.g. licence fees). At this point the author reminds that if CADT sets a higher rate than AIT (which is a rather hypothetical situation), the lower rate in AIT will be applied. If a taxpayer errs and withholds the tax rate according to AIT which is higher than that set in the relevant CADT, then the tax that may be credited subsequently in the tax return is the tax set in the relevant CADT. This solution is also valid for the situation when the so-called refunding system is applied in relation to the withheld tax. This is the situation when the payer withholds tax according to the national regulation and the taxpayer has the possibility to apply for the refund of the tax overpaid (i.e. the tax amount above the limit set in the CADT), if any.

Table 3: Incomes that are liable to a new tax regime

Provision of Section 22, AIT		Income type	Corresponding CADT Article[11] for the given type of income
Type I	paragraph 1 letter c)	Incomes from services except for carrying out construction and erection projects, incomes from marketing, technical or other consultations, managing and agency activities and similar activities in the Czech Republic,	Article 5 – Permanent Establishment
	paragraph 1 letter f)	1. from independent activities, for example, of an architect, physician, engineer, lawyer, scientist, teacher, artist, tax or accounting adviser, and similar professions, carried out in the Czech Republic,	Article 7 – Business Profits
		2. from personally performed activities in the Czech Republic or here evaluated of a publicly performing artist, sportsman, artiste and co-performing persons, regardless of who receives these incomes and from what legal relationship,	Article 17 – Artistes and sportsmen
Type II	letter g)	1. compensations for granting the right for using or for using an industrial ownership object, computer programs (software), production and technical and other economically usable knowledge (know-how),	Article 12 - Royalties
		2. compensations for granting the right for using or for using a copyright or a right similar to copyright,	
		4. interest and other revenues on granted credits and loans and similar incomes gained from other business relations, from deposits and from investment instruments according to a special legal regulation regulating the capital market business,	Article 11 – Interest
		5. incomes from using a movable or its part in the Czech Republic,	Article 12 - Royalties
		6. remunerations of the Members of statutory bodies and other bodies of legal entities,	Article 16 – Director´s fee
		12. sanctions from liability relations,	

Source: own elaboration.

11 ** The model OECD convention has been chosen with regard to the fact that conventions concluded with Member States are based on this model and even if there are some differences (e. g. an absence of a special regulation for some type of income), the existing CADT are basically very similar. ** Due to the wording of the respective CADT and AIT, some of the incomes may fall under other than the cited articles (e.g. some conventions have a special provision for so-called independent occupations, e. g. CADT with Italy). The wording of a specific CADT and the relevant provision of AIT are decisive.*

3.1 Advantage of the new regime

In spite of the fact that the explanatory report to Act No. 216/2009 Coll. does not contain any reasoning of adoption of this regulation, the author thinks that this regulation has been adopted to reach greater compliance with the Community Law. Before introducing the new regime relating to tax residents of the EU and EEA Member States, this group was strongly disadvantaged compared to tax residents as it could not apply related expenses in a number of cases (the tax liability was assumed to be fully settled by withholding the tax at the source by the payer). To demonstrate the advantage for tax non-residents who are at the same time tax residents of an EU Member State, a model example is further considered. The model example compares the taxation of the selected type of income, included under new Section 36 paragraph 7, according to the regulation until 19 July 2009 and from 20 July 2009[12].

Example:

The taxpayer is a tax resident of a Member State of the EU and he has gained an income from sources in the CR as a publicly performing artist. The respective CADT enables to tax this income in the CR.

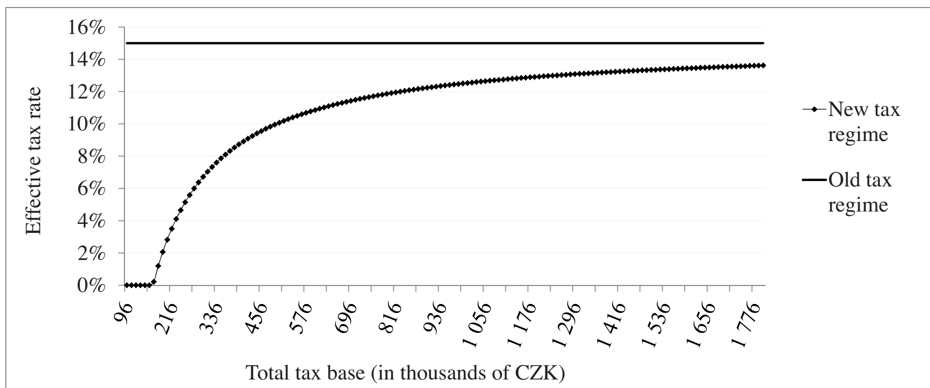
1. According to the original regulation (designated as the "old" taxation regime), the payer would have withheld a withholding tax from the gross income in the amount of 15% and the taxpayer's tax liability would have been fully settled in this way.
2. According to the new regulation (designated as the "new" taxation regime) the payer will also withhold a withholding tax at the source from the gross income. However, this income in the gross amount is included by the taxpayer in his tax return where the respective expenses according to AIT may be subtracted from it and the withheld tax amount may be credited to the final tax liability. Of course only expenses eligible according to AIT may be applied.

The model of determining an effective tax rate from which the graphs below (Diagram 1 and Diagram 2) result is based on the following starting points and simplifications:

- The basic tax abatement per taxpayer is applied in the amount of CZK 24,840 (Section 35ba paragraph 1 letter a) of the AIT), to which the taxpayer (including a tax non-resident) is entitled without having to fulfil any other conditions;
- other forms of tax reliefs (tax abatements, tax allowance per child or non-taxable parts of tax base) are not considered;
- expenses amounting to CZK 0.00 are considered, i.e. the tax base is identical to the gross income from which the tax was withheld;
- the range of the gained annual tax base (income) is considered from CZK 96,000 to CZK 1,800,000;
- the effective tax rate (ETR) is given as the ratio of the final tax liability to the tax base.

12 Author reminds already given fact that the new regime of taxation can be used already for the year 2009.

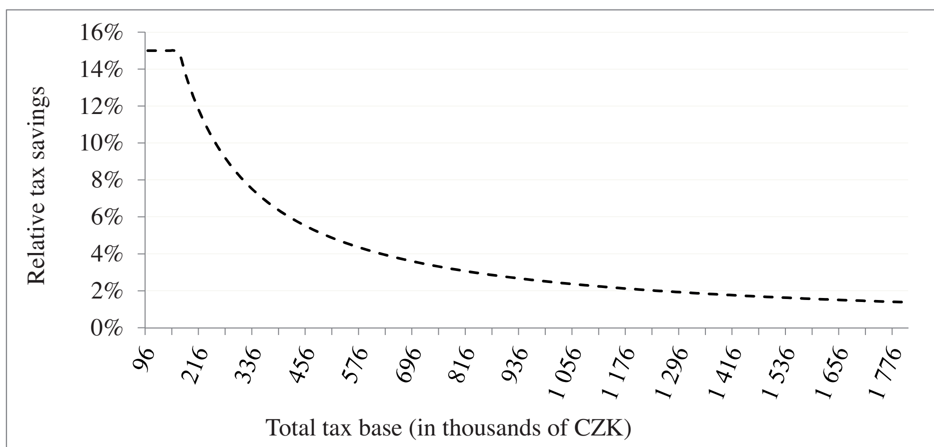
Diagram 1: Comparison of the effective tax rate for the "old" and "new" tax regime



Source: Own elaboration

The diagram above shows a clear advantage of the new tax regime for tax non-residents. However, this consideration does not include possible costs of tax non-residents connected with filing a tax return and other administrative costs. This advantage for the tax period is given particularly by a high amount of the basic tax abatement per taxpayer. The effective tax rate has a progressive character for the "new" tax regime, which is given by the fact that the relative percentage of this abatement decreases with the growing income. Even if we consider the situation when a taxpayer does not deduct any relevant expenses (i.e. the gross income is equal to the tax base itself), it happens that up to the gross income of CZK 165,600 the final tax liability of a tax non-resident is zero. The following diagram (Diagram 2) represents the amount of tax savings of the "new" regime compared to the "old" one.

Diagram 2: Relative tax savings resulting from the newly introduced regime



Source: Own elaboration.

In conclusion, it may be stated that the regime according to Section 36 paragraph 7 of the AIT for tax residents of the EU and EEA Member States for the tax period of 2009 for whom it will be used for the first time is advantageous. If we extend these considerations by taking the time factor into account, then it is true that the advantages for a tax non-resident will follow from this tax regime with a certain time delay. It must be taken into account that the tax withholding by the payer will be also realized – in this there is no difference to the "old" tax regime. So the taxpayer will only be able to dispose of the net income (gross income minus the withheld tax). He will be able to use the advantages of the newly introduced regime only within the filed tax return where the withheld tax amount will be credited to the final tax liability.

Conclusion

To sum it up one can observe that even the area of direct taxation of incomes from employment and from enterprise and other self-employed gainful activities is affected by the European Union Law despite the fact that there is no regulation or directive for this issue. In this respect, the sovereignty of a Member State to set its own regulation has been broken on the part of European Union[13] with the aim to ensure factual fulfilment of basic freedoms that represent headstones for EU functioning.

Author thinks that with regards to the conclusions of the ECJ it can be summarized that the basis for reaching the compliance of the taxation of a tax non-resident who is at the same time a national of, and resides in, another EU Member State includes two basic attributes:

1. to secure the possibility for this group of taxpayers to deduct, in relation to the reached income in the territory of the Czech Republic, the relevant expenses provided that also the tax residents of the CR have this possibility and
2. to enable this group of taxpayers from other Member States to apply, under adequate conditions, also tax reliefs (non-taxable parts of tax base, tax abatements and tax allowance) to which, as a standard, the tax residents of the CR are entitled.

With regard to what has been mentioned above, author thinks that in many respects AIT at present fulfils both of the mentioned attributes. Also the changes brought by Act No. 216/2009 Coll. have positively contributed to this. When speaking of Act No. 216/2009 Coll. it is to stress that this amendment to AIT brought positive changes for a tax resident of an EU Member State. In this respect we can observe with high probability that most of tax residents of EU Member States are those who are at the same time nationals of some of EU Member States. However, there still can be a group of taxpayers who are nationals of some of EU Member States but who are not at the same time tax residents of some of an EU Member States. Such taxpayers, according to the Czech valid and effective regula-

13 The relevant ECJ case law which represents a source of law for taxation of aforesaid incomes relates to cases, where discrimination between a national of the State of the source of respective income and a national from another Member State occurs. At the same time it is necessary to observe that it does not mean total equality between nationals of different member States.

tion, will not be able to use the new regime of taxation implemented by Section 36 Para 7 of AIT.

In relation to the other above-mentioned points, it is useful to note that with effect since 01 May 2004 (the CR's joining the EU), the so-called "90% rule" has been applied in AIT, i.e. the possibility to apply other tax reliefs by tax non-residents[14] provided that the summary of their incomes from sources in the Czech Republic according to Section 22 of the AIT amounts at least 90% of their entire incomes. Concerning the tax residents of another Member State the AIT also states, with effect since 01 January 2004, the exclusion of securing the tax according to Section 38e of AIT in a case a payer performs on behalf of a tax resident of an EU or an EEA Member State.

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14 *In this respect there is no differentiation between tax non-residents from EU Member States and other tax non-residents.*

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Contact address / Kontaktní adresa

Ing. Karel Brychta, Ph.D.
Dep. of Finance
Brno University of Technology
Faculty of Business and Management
(brychta@fbm.vutbr.cz)