Taxation – Lecture 4

DIRECT TAX SYSTEM:
CORPORATE INCOME TAX
(EVIDENCE FROM THE CZECH REPUBLIC)

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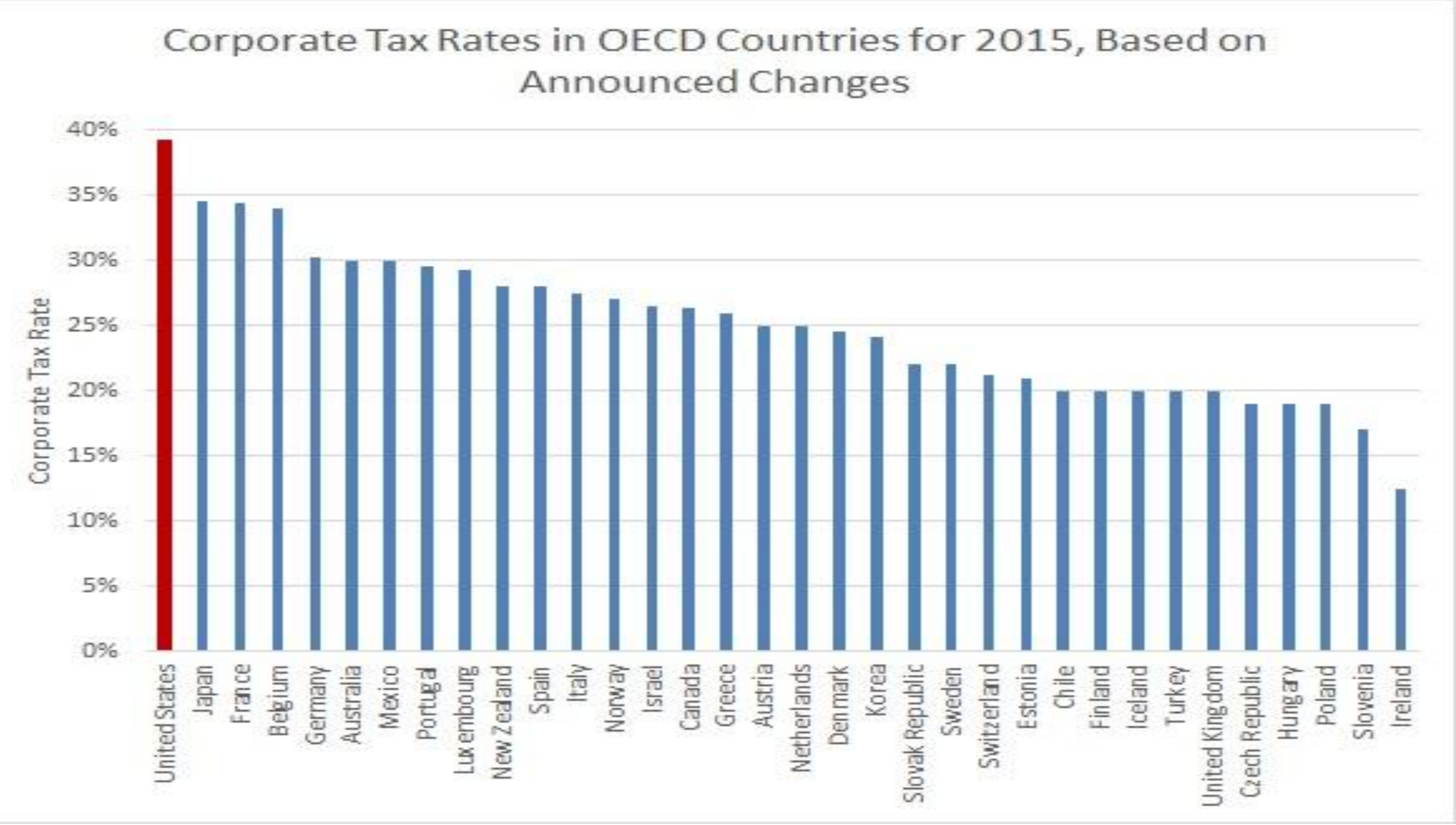
Corporate income tax (CIT)

- The second income tax in the Czech Republic is the **corporate income tax** regulated together with the personal income tax in the **Income Taxes Act (ITA).**
- This direct tax, especially tax rate, is very important for all entrepreneurs and investors from abroad.
- **Income from all activities and from the management of all types of property is liable to tax**. There are just **a few incomes that are not liable to tax and several exceptions.**

Corporate income tax (CIT)



Corporate income tax (CIT)

- **Exemptions from corporate income tax:**
  - **membership fees**,
  - income from **collections in churches**,
  - income of **state funds**,
  - income received in connection with the **performance of volunteer activities,**
  - incomes of the **Central Bank of the Czech Republic**,
  - income from the **operation of lotteries and similar games of chance,**
  - **interest on mortgage bonds**,
  - income from **inheritance or legacy**,
  - etc.

Corporate income tax (CIT)

- **The taxpayers are entities** such as:
  - **companies** (limited partnerships, limited liability companies, public limited companies and co-operative societies)
  - **civil corporations, political parties**,
  - **interest corporations, foundations**
  - **banks, insurance corporations, exchanges**,
  - **municipalities, state corporations**,
  - **investment corporations and investment funds, state funds, pension funds,**
  - **churches, organizational components of state**,
  - **public beneficial companies** (the main activity is not business, but public beneficial activities)
  - etc.

CIT - calculation

- The way to calculate the tax of corporate income and income from self-employment is quite similar.
- The taxpayer can read the **economic income** (it means **incomes reduced by the expenses incurred to generate, assure and maintain income**) **from the bookkeeping**. This is the **tax base <u>which is not final</u>, <u>it shall be reduced by items deductible from the tax base.</u>**
- **Expenses ineligible to generate, assure and maintain income** according to ITA:
    - **representation expenses** (treat, entertainment, gifts),
    - **personal expenses of the taxpayer**,
    - **expenses on non-alcoholic beverage provided to employees** by the employer at the workplace,
    - **penalties, penalty interest and fines**,
    - **shortages and damages beyond compensation**,
    - **expenses beyond limits determined by the ITA**

CIT - calculation

- **The tax base shall be reduced by using items deductible from the tax base:**
    - **tax loss** which was recorded and assessed **in five previous taxable periods,**
    - **100% of costs for R&D**,
    - **110% of costs for the acquisition of assets for vocational training,** if the assets are used for the training of **more than 50% of the time of its operation in three consecutive tax periods,**
    - **50 % of costs for the acquisition of assets for vocational training**, if the assets are used for the training **between 30% and 50% of the time of its operation in three consecutive tax periods.**
- **The tax base reduced by items deductible from the tax base should be taxed by the tax rate**.
- **In the Czech Republic corporate income tax rate is 19%.**

CIT - calculation

- **This tax is not final, the taxpayer can use several options of tax reductions:**
  - **18 000 CZK for every disabled employee**,
  - **60 000 CZK for every severely disabled employee**,
  - other tax reductions for the taxpayer of personal income tax.
- **The tax administrator is the Financial Office determined by the location of the registered office of the taxpayer.**
- **The taxpayer must submit his tax return at the latest three months following expiry date of the taxable period (usually 31st March).** If the tax return is prepared and submitted by the tax advisor or barrister, the tax return shall be filed latest six months following expiry date of the taxable period. Before the 31st March, a power of attorney authorizing such representation must be submitted.

CIT - calculation

- **The taxpayer of corporate income tax can choose, whether he will use a calendar year or an economic year (which must begin on the first day of any month and must be twelve months long) as a taxable period.**

CIT – depreciation

- According to the Accounting Act the **owner must set up the limit of input price for classification the asset as tangible or intangible fixed asset.**
- **For each asset**, the owner has to **determine the operational and technical function period.**

Accounting depreciation (amortization) =

input cost / determined number of years

- **Tax depreciation (amortization) has to be considered in the tax return of income (personal => self-employed, or corporate)**. However, **accounting depreciation (amortization) reflects the actual condition of the real assets much better.**

CIT – depreciation of tangible FA

- **The tangible fixed asset is asset, which has its acquisition cost <u>higher than 40 000 CZK</u>** and has the **operational and technical function <u>exceeding one year</u>.**
- **<u>Land, pieces of art and cultural heritage are not depreciated.</u>**
- The tangible fixed assets is **depreciated by the owner.**
- In the first year the depreciator **classify the asset into one of these depreciation groups** (see next slide).
- According to the ITA there are two possible ways for depreciation of tangible fixed assets: **linear or accelerated.**

CIT – depreciation of tangible FA

Tax depreciation periods for tangible assets

Depreciation group	Depreciation Period	Examples of Assets
1	3 years	bicycles, computers, tools, breeding animals
2	5 years	furniture, guns, cars, motorcycles, music instruments, books
3	10 years	greenhouses, bridges, elevators, boats, trains
4	20 years	buildings, swimming pools, power stations,
5	30 years	motorways, roads, aqueducts, fountains, wells, tunnels
6	50 years	building of museum, library, hotel, church, mall

CIT – depreciation of tangible FA

Annual depreciation = input costs * relevant annual rate

Depreciation rates for tangible FA under straight-line method (in %)

Depreciation group	Annual rate in 1st year of depreciation	Annual rate in other years of depreciation	Annual rate for increased input costs
1	20	40	33,3
2	11	22,25	20
3	5,5	10,5	10
4	2,15	5,15	5
5	1,4	3,4	3,4
6	1,02	2,02	2

where the depreciation rate for the **first three groups** are **increased by 10% in the first year:**

1	30	35	33,3
2	21	19,25	20
3	15,4	9,4	10

CIT – depreciation of tangible FA

Accelerated method:

Annual depreciation in 1st year =

input costs / coefficient for 1st year

Annual depreciation in 1st year =

2 * amortized cost) / (coefficient for other years – n)

where n = number of years in which the tangible fixed assets were depreciated

CIT – depreciation of tangible FA

Annual depreciation = input costs * relevant annual rate

Depreciation coefficients for tangible FA under accelerated method

Depreciation group	Annual rate in 1st year of depreciation	Annual rate in other years of depreciation	Annual rate for increased input costs
1	3	4	3
2	5	6	5
3	10	11	10
4	20	21	20
5	30	31	30
6	50	51	50

CIT – depreciation of tangible FA

- **Example:** Calculate linear and accelerated depreciation of Lamborghini, input price 2 000 000 CZK.

CIT – depreciation of tangible FA

- **<u>Example:</u>** Calculate linear and accelerated depreciation of Lamborghini, input price 2 000 000 CZK.

Linear depreciation

Year	Input Price	Annual Rate (%)	Depreciation	Amortized Cost
1	2 000 000	11	220 000	1 780 000
2	2 000 000	22,25	445 000	1 335 000
3	2 000 000	22,25	445 000	890 000
4	2 000 000	22,25	445 000	445 000
5	2 000 000	22,25	445 000	0

CIT – depreciation of tangible FA

- **<u>Example:</u>** Calculate linear and accelerated depreciation of Lamborghini, input price 2 000 000 CZK.

Accelerated depreciation

Year	Input Price	Coefficient	Depreciation	Amortized Cost
1	2 000 000	5	400 000	1 600 000

Year	2 * Amortized Cost	Coefficient - n	Deperciation	Amortized Cost
2	3 200 000	6 - 1	640 000	960 000
3	1 920 000	6 - 2	480 000	480 000
4	960 000	6 - 3	320 000	160 000
5	320 000	6 - 4	160 000	0

CIT – depreciation of intangible FA

- **The intangible fixed asset is asset, which has its acquisition cost higher than 60 000 CZK** and has the **operational and technical function exceeding one year.**
- The intangible fixed assets is amortized by the owner.

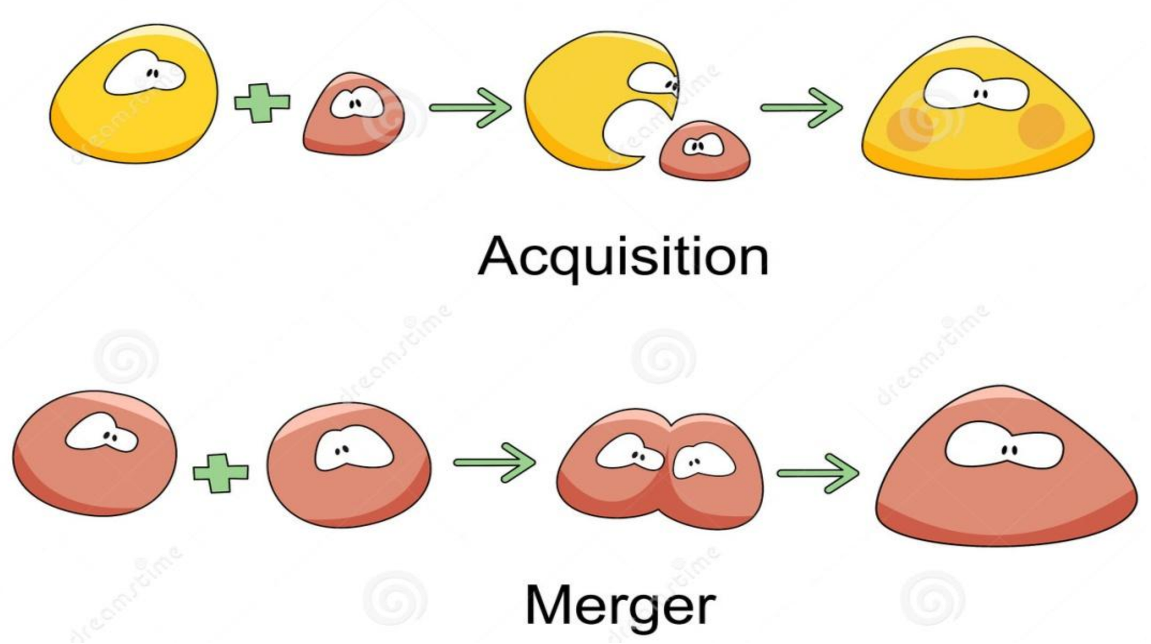
Annual amortization =

input costs / number of years (months) for which the owner has the right to use

- Other cases:
    - audiovisual work – 18 months
    - software and intangible results of research and development – 36 months
    - formation expenses – 60 months
    - other intangible fixed assets – 72 months

CIT – M&A

- **Acquisition** – a corporate action in which **a company buys most** (if not all) **of the target company's ownership stakes in order to <u>assume control of the target firm</u>.**
- **Merger** - **the combining of two or more companies**, generally by offering the stockholders of one company securities in the acquiring company in exchange for the surrender of their stock.



CIT – M&A

- After the Czech Republic joined the European Union, Council **Directive no. 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies** of different Member States, significantly affected the Czech tax legislation.
- **The Directive regulates tax neutrality of mergers. Taxation in the Member States have no impact on the decision by the merger.**
- Due to the fact that the **mergers relate to trading companies they are subjected to the corporate income tax.**
- **The defunct company in the merger has the obligation to file a tax return for the period** (resp. part of the period) **preceding the decisive day.**
- **The acquiring company has to submit a tax return for the period preceding the decisive day, as well as for the period starting from that date.**

CIT – M&A

- **The decisive day** is defined as the **date from which the transactions of defunct company are considered** (for accounting purposes) **as act of the acquiring company.**
- **Defunct company closes the accounts on the day preceding the decisive day.**
- For the tax period **from that date until the merger is registered in the Companies Register** (dissolution of the company) generally **there is no obligation to file a tax return.**
- **Acquiring company** has **two possibilities for submitting a tax return depending on the decisive day:**
  - **If the decisive day is the 1st day of a calendar or an economic year**, the company submits the **tax return according to normal rules for submitting the tax return of corporate income tax.**
  - **otherwise the company must submit tax return of corporate income tax for a period ending on the day**

CIT – M&A

preceding the decisive day by the end of the month following the month with the decisive day.

- If the merger is **registered in the Companies Register by the end of the year with the decisive day**, **the taxable period does not exceed 12 months.** If the merger is **registered in the Companies Register in the next year after the year with the decisive day, the taxable period exceeds 12 months.**
- **Items such as tax provisions, tax reserves, tax depreciation and amortization, tax loss, tax deductible items that have not yet been claimed and others are transferred from the defunct company to the acquiring company.**
- **Acquiring company continues in depreciation and amortization of assets.**

Appendix: Tax evasion

- **Effective tax policy** is not simply **a matter of deciding on the taxes that people should pay**, but also of **ensuring that they actually do pay what they should.** The **practical operation and enforcement of the tax system** is every bit as important as the **structure and rates of tax** in ensuring that **revenues are raised efficiently and fairly**. To a significant extent, **good tax compliance is what distinguishes well functioning states from chaotic and ineffective ones**. Greece and Germany, for example, employ many of the same taxes. The most significant difference in the functioning of their tax system is the extent of evasion.

Appendix: Tax evasion in PIT - opportunities

- **Most tax evasion takes place in a context where taxpayers - individuals or firms - are required to report income or spending to the tax authorities**. Often this takes the form of **an annual tax return**, which has to be completed **with details of relevant income or sales during the preceding year together with other information relevant to their tax liability**, and **filed (submitted) by a particular deadline.** The opportunities for tax evasion principally arise through the scope to make false or incomplete statements in the tax return without prompting a successful challenge by the revenue authorities. This can be done through:
  - **underdeclaration of incomes received** - the taxpayer declares a lower income than they actually received, or for a sales tax, a lower level of sales.
  - **false or exaggerated claims for deductions or allowances against tax**
    - if an income tax system allows the **cost of donations to**

Appendix: Tax evasion in PIT - opportunities

charity to be deducted from gross income, before tax is computed, then a taxpayer may try to reduce their tax payment by **exaggerating the amount of money they have donated to charitable causes.**

- If the **cost of mortgage interest**, **children's schooling, or commuting expenses** can be offset against income tax, **taxpayers can claim a higher level of costs than they have in fact incurred.**

- In each case, however, **the basic sequence of events is the same**: **the taxpayer provides <u>misleading information</u>** which would **<u>reduce their liability to tax</u>**, and **keeps their fingers crossed that the <u>revenue authorities cannot spot the lie.</u>**
- More rarely in most developed countries, tax evasion can take the form of **completely hidden activity which lies entirely out of view of the revenue authorities**. It may be possible for individuals to work or to trade as a business without the revenue authorities being aware

Appendix: Tax evasion in PIT - opportunities

of their existence at all – so-called **‘ghosts’,** in the jargon used by some tax authorities.

- **Not all taxes offer equal opportunities for evasion to every individual taxpayer.** The **scope for income underdeclaration by employees is often very limited**:
  - Many tax systems require **employers to report the amount of income they have paid in wages to each individual employee**, and the authorities can **use this information to crosscheck the figures that the taxpayer puts in their tax return**.
  - Many tax systems require the **employer to withhold tax from wage payments, and to remit this directly to the revenue authorities.** Except in very small firms, **long-term collusion between employers and employees to make coordinated false reports of wage payments is unlikely** - it would only require **one disaffected employee to ‘blow the whistle’ on such an arrangement.**

Appendix: Tax evasion in PIT - opportunities

- The opportunities for employees to evade tax on their wage income are then limited to **making exaggerated claims for deductions and allowances,** and the scope for this may also be limited if the **tax system confines deductions to those where there is scope for independent reporting and verification**.
- Many countries also use **systems of reporting to crosscheck taxpayer declarations of investment incomes - bank interest**, etc. Often, **the only scope that taxpayers have to evade tax on investment income is to <u>hide their investments abroad</u>, beyond the scope of direct surveillance by the tax authorities**. But such arrangements can come dramatically unstuck if information comes into the possession of the revenue authorities. Recently a number of European countries have been offered computer disks containing details of their taxpayers who hold undeclared accounts in Liechtenstein and Swiss financial institutions.

Appendix: Tax evasion in PIT - opportunities

Using this data windfall, some European countries have been vigorously investigating and prosecuting evaders.

- By contrast, **nearly all tax systems are much more exposed to tax evasion by the self-employed** – people working on their own account, or the owners of small unincorporated businesses. Part of the reason for this is that the **self-employed are in much greater control of the information to be reported**; they do not have an employer who may separately report their income to the authorities. In addition the **definition of income for the self-employed is more complex and far less clear cut than for employees**, requiring an element of judgment about which different people could reasonably reach different views. **Since the boundary between true and false income is imprecise, self-employed taxpayers have scope to exploit the ambiguity.**
  - For example, most tax systems **allow people working in a self-employed capacity to deduct from their gross income**

Appendix: Tax evasion in PIT - opportunities

the costs of the equipment and materials they have used in the course of their business activity, and **an individual's tax liability can be reduced by exaggerating these costs**. The boundary between the costs of a business and the individual's own consumption can be very blurred indeed. For example, **when someone runs a business from home, how much of the cost of their home, their furniture, their telephone bill, their car, and other spending should count as part of the cost of the business?** When the boundary is blurred in this way, there is probably a long way that taxpayers can push things, before the revenue authorities can seriously challenge the judgments they are making.

Appendix: Tax evasion in CIT - opportunities

- With **corporation taxes, revenue losses** through **outright fraud and evasion** are probably less significant than two distinctive categories of revenue loss. Both of these come under the heading of tax avoidance rather than evasion. While **tax evasion is clearly illegal, avoidance is less easily defined.** It **involves organizing the taxpayer's affairs, within the boundaries set by the ruling tax legislation**, **so as to minimize the taxpayer's tax liability.** In principle, therefore, **it lies wholly within the letter of the law** - if not the spirit, since much avoidance exploits contrived situations, undertaken with the primary purpose of avoiding tax.
- **Substantial corporate tax revenues are lost through the aggressive exploitation of loopholes, blurred boundaries, and ambiguities in the tax system**. Businesses that engage in **aggressive tax planning** of this sort can often make a huge return on the resources they invest in fighting legal

Appendix: Tax evasion in CIT - opportunities

cases, and they know that **in many cases the tax authorities will be unable or reluctant to match their legal weaponry**. The problem for society is that **such battles are wasteful of potentially productive resources.** Instead, lawyers have to be engaged, not in producing something of real value, but in shifting, or contesting the shifting, of resources from the public sector to the pockets of firms. **Tax authorities have to make a difficult judgement of how much public money to devote to fighting such cases, when there are easier, and less wasteful, ways of raising additional revenues**. Undoubtedly, the world would be a better place without aggressive tax planning and speculative litigation, but **since these activities are essentially legal, it is difficult to see how they can be prevented**. It can help if tax legislation is clear and leaves few loopholes to exploit, but this is easier said than done.

Appendix: Tax evasion in CIT - opportunities

- **Massive revenues, too, are lost through international corporate tax avoidance**. Multinational companies have **opportunities to structure themselves in a way that minimizes their liability to taxes in countries where they conduct their business**, and instead to shift the profits they earn to lower taxed jurisdictions and tax havens where they may pay no tax at all. **Profits can be shifted through a number of mechanisms**, in particular through **<u>transfer pricing</u> - manipulation of the prices at which the business charges its internal transactions between subsidiaries in different countries** - and through **<u>charges for the use of the business's intellectual property</u> - rights, patents, and the like. In both cases, <u>a business unit in a high-tax country can be charged high prices for these internal transactions</u>, reducing the profits earned in the high-tax country, and <u>enabling the profits to be relocated</u> elsewhere in the organization, <u>in places where they will be taxed less.</u>**

Appendix: Tax evasion – risks and gains

- **What determines whether an individual taxpayer decides to evade tax, given the opportunity, and by how much?** Some insights can be obtained from a simple economic framework, in which **individuals decide whether to evade tax, and how much tax to evade, based on <u>a comparison of costs and benefits</u>** - weighing up, on the one hand, the **<u>gains from evasion in terms of unpaid tax</u>**, and, on the other hand, the **<u>risks of being caught and penalized</u>**.

- **<u>Example:</u>** An individual faces an opportunity to be honest or dishonest about the receipt of a particular one-off payment, for example, of EUR1,000. In the absence of any moral considerations, the individual might weigh up the consequences of dishonesty, which amount to the tax saving they would make if they were successful in evading tax, and, if they were unsuccessful, the penalty they would face. If we suppose the tax rate to be 20 per cent, and the penalty for evasion to be twice the level of the tax, plus payment of the tax due,

Appendix: Tax evasion – risks and gains

then evasion offers a benefit to the individual in the form of a tax saving of EUR 200 if they are undetected, and a cost of EUR 400 if they are caught and fined. In both cases these amounts are measured against the alternative, which is honestly paying the tax that is due. It will be clear that a crucial element in the calculation of the consequences of evasion will be an assessment of the risk of being detected and punished. **If the probability of detection is sufficiently high, the potential evader may think that the potential tax saving is not worth the risks involved.**

- If the only reason that individuals comply is fear of detection and the penalty that would be levied, then **the actual rates of investigation and penalties are insufficient to explain what appear to be relatively high levels of tax compliance across the population as a whole**. **Why do so many people pay their taxes, when the risks of noncompliance are so small?**

Appendix: Tax evasion – risks and gains

- **Many taxpayers are very risk-averse** and prefer the certainty of tax compliance against the risky gamble of evasion.
- **Taxpayers overestimate the risks involved in tax evasion**. They believe that the tax authorities are more all-seeing than they actually are, or that the punishments for evasion are much more drastic.
- **Significant moral and psychological elements in tax evasion decisions**. Some taxpayers may comply, not because they fear detection and punishment, but through a sense of moral obligation or 'civic duty', while others may comply because they care about their reputation in the community, or their own self-image.

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