

1. Policy

The Czech Republic uses two principles as a basis for income taxation – residence and source. Taking into account both Czech domestic law and current treaty policy we can conclude that the Czech Republic’s treaty policy is to obtain slightly more source taxation than is generally allowed by the OECD model convention. This can be seen in the article “Permanent establishment” and in the article “Royalties” of the treaties concluded by the Czech Republic. The Czech Republic also included reservations to the OECD model convention in these articles.

The Czech Republic insists on using the time test not only for building sites but also for the furnishing of services. The concept of permanent establishment (PE) in recent treaties is thus much wider and more situations are deemed to create PEs without a fixed place of business. This trend started approximately in 1994 when a similar provision was adopted in domestic law.

Another example of more stress on residence taxation is rental income from leasing of equipment. Though the model convention shifted this income to the article “Business income”, the Czech Republic insists on having it in article 12 and on taxing it by a withholding tax. The Czech Republic has also not been willing to exempt copyright royalties since 1996. From that time it started to ask treaty partners for a unified rate of 10 per cent for all types of royalties.

As regards changes in respect of the Czech Republic’s accession in the EU there is a shift towards residence taxation of dividends in domestic law based on the implementation of the Parent–Subsidiary Directive. The same holds for interest paid between associated enterprises based on the Interest–Royalties Directive. In respect of royalties the Czech Republic still firmly insists on source taxation. Therefore it asked for a transitional period which was approved by the EU bodies; the Czech Republic will refrain from source taxation only after 2010.

During the last 15 years no other proposals involving changes from residence to source, or source to residence, taxation have been discussed in the Czech Republic. There has not been any study on the costs/benefits of tax treaties, or of

* Tax Consultant, KPMG, Prague

certain treaty provisions concerning the taxation of elements of income or of any shift between source/residence taxation.

2. The Czech Republic's taxation as a country of residence

The Czech tax system is a typical universal system, i.e. residents are taxed on their worldwide income. This system was designed as such in 1992 and has been in effect from January 1993. Since then it has not changed in this respect.

The law does not stipulate particular categories of foreign income earned by residents. It only determines that resident taxpayers have tax liability on income from Czech sources as well as from foreign sources. This means that any foreign income that is not tax exempt under general rules covering any income is taxable in the Czech Republic. The Czech Income Tax Act does not include any source rules for the foreign income of resident taxpayers. The law uses the term "income from foreign sources" without defining it.

Czech law does not specify the method of double tax relief for any foreign income. The credit method and the exemption method as unilateral relief were abolished in 2002. Therefore no specification follows in this analysis for particular categories of income. Czech law refers to international treaties. In the case of non-treaty countries the only method available to alleviate double taxation is the deduction method. Thus the result is that double tax treaties in any case bring more generous treatment.

The treaty approach is to provide for the credit method for all types of income. This is the trend started at the beginning of the 1990s. In the treaties concluded in the 1970s and 1980s the credit method was used for interest, dividends, royalties and the income of artistes and sportsmen and the exemption method was used for business profits, capital gains, employment income, income from independent services, rental payments, pensions and other categories of income.

2.1. Income of domestic PEs

Rules for the determination of the tax base for domestic PEs of foreign entities are the same as for resident taxpayers. This means that all income attributable to a PE, including a foreign one, is taxable in the Czech Republic. However, Czech law does not provide for the relief of double taxation of the PE's income that would arise if the income were taxed in the other country. This is the effect of the abolition of unilateral relief in 2002. PEs are in the same position as residents with income from a non-treaty country, i.e. they can only use the deduction method.

2.2. Anti-avoidance provisions

Czech law does not contain any controlled foreign company rules, any foreign income fund rules or any other mechanisms to tax the foreign income earned by Czech residents through foreign intermediaries. Nor does the law contain any

rules regarding taxation of income flowing from tax havens. Czech law also does not provide for different treatment of resident companies based on whether they are primarily foreign owned or domestically owned.

On the other hand, there are no relieving provisions for certain categories of individuals who are residents but not domiciled in the Czech Republic. The concept of residence for individuals is quite wide and includes factual presence in the territory of the Czech Republic for a certain time and also having a home available with the intention of staying there permanently. This intention might be interpreted very widely, so if an individual registers at a permanent home for inhabitant registration purposes, and then works for several years abroad, he might still be considered a resident as the permanent address might indicate an intention to stay there permanently.

3. The Czech Republic's taxation as a country of source

The Czech Republic employs the source principle as another basis, besides the residence principle, for the taxation of income. Unlike the foreign source of residents' income, the domestic source of non-residents' income is defined in the law. A special article called "Source of income" is wholly devoted to definitions of Czech source income and it lists in a taxation mode sources of particular types of income. The tax on domestic income of non-residents is collected by way of final withholding or by way of assessment. Withholding tax is levied on gross income paid, while in the case of assessment the taxpayer is allowed to deduct connected expenses. The rules that govern application of tax-deductible expenses are identical both for resident as well as non-resident taxpayers. Table 1 shows the basis for taxation for particular income having its source in the Czech Republic earned by a non-resident, and whether the amount is net or gross.

The Czech Republic has not developed a general approach to determining the geographical source of income. Instead for each category of income the law stipulates a specific source rule. Generally the source rules can be grouped into three classes:

- an activity performed in the territory of the Czech Republic;
- an asset situated in the territory of the Czech Republic;
- income paid by a resident person or by a PE of a foreign entity situated in the territory of the Czech Republic, sometimes combined with another narrowing rule.

3.1. The Czech law rule for particular types of income

3.1.1. Business profits (excluding services) attributable to a PE

The rule says that income earned from activities performed through a PE has its source in the Czech Republic. A definition of a PE is attached to this rule.

Table 1. The Czech Republic's domestic law treatment of income earned by a non-resident

Type of income	A. Does the Czech Republic tax this income when earned by a non-resident?	B. Is the non-resident taxed on a net or gross basis (i.e. can he deduct relevant expenses)?	C. At what rate is the non-resident taxed?
Business profits (excluding services) attributable to a local PE	Yes	Net basis	Corporations: 28% (26% from 2005), individuals: progressive rates
Business profits (excluding services) not attributable to a local PE	No		
Dividends paid to a foreign parent	Yes	Gross basis	15% or exempt when paid to EU parent company
Dividends paid to a foreign portfolio shareholder	Yes	Gross basis	15%
Independent services rendered by professionals and consultants	Yes	If a PE is available: net basis; otherwise gross basis	Net taxation: progressive rates Gross taxation: 25%
Independent services by artistes and athletes	Yes	Gross basis	25%
Employment income	Yes	Net basis (only social security and health insurance contributions are tax deductible)	Progressive rates
Shipping and air transport income	No special rules – the same rules as for business income apply		
Rental payments for immovable property	Yes	Net basis	Corporations: 28% (26% from 2005), individuals: progressive rates
Interest	Yes	Gross basis	15%

Table 1. (cont.)

Type of income	A. Does the Czech Republic tax this income when earned by a non-resident?	B. Is the non-resident taxed on a net or gross basis (i.e. can he deduct relevant expenses)?	C. At what rate is the non-resident taxed?
Rental payments for equipment (not a financial lease)	Yes	Gross basis	25%
Royalties	Yes	Gross basis	25%
Capital gains on shares	Yes	Net basis	Corporations: 28% (26% from 2005), individuals: progressive rates
Other capital gains	Yes	Net basis	Corporations: 28% (26% from 2005), individuals: progressive rates
Pensions	Exempt up to CZK 144,000 annually, the amount over the threshold – yes	Net basis (however, no deductible expenses are allowed)	Progressive rates
Directors' fees	Yes	Gross basis	25%
Wins in lotteries, prizes from contests, competitions	Yes	Gross basis	20%
Income from acquired receivable when it is received from the debtor	Yes	Net basis	Corporations: 28% (26% from 2005), individuals: progressive rates

3.1.2. Business profits (excluding services) not attributable to a PE

Referring to section 3.1.1, income not earned through a PE is not taxable in the Czech Republic. The law includes a separate rule on performing services rendered in the territory of the Czech Republic. There is no interaction between this rule and the rule on a PE.

3.1.3. Dividends paid to a foreign parent and to a foreign portfolio shareholder

The source rule for dividends is payment by a Czech subsidiary or a domestic PE. Dividends are generally taxed by final withholding tax of 15 per cent and this rate is subject to relief under particular double tax treaties. The only exception is pay-

ment of dividends to an EU residing parent company when the dividends are exempt from taxation.

3.1.4. Income from independent services rendered by professionals and consultants

The source rule is the performance of the activities in the territory of the Czech Republic.

3.1.5. Income from independent services by artistes and athletes

The source rule is the performance of the activities in the territory of the Czech Republic.

3.1.6. Employment income

The source rule is the performance of the activities in the territory of the Czech Republic or on board a ship or aircraft operated by a resident taxpayer. The income is exempt if the employment is neither performed with a domestic employer, nor with a domestic PE, and not performed for more than 183 days.

3.1.7. Rental payments for immovable property

The source rule is the situation of the immovable property in the territory of the Czech Republic.

3.1.8. Rental payments for equipment

The source rule is a combination of two aspects: payment by a Czech person or a domestic PE and the situation of the equipment in the territory of the Czech Republic.

3.1.9. Royalties

The source rule is payment by a Czech person or a domestic PE.

3.1.10. Capital gains on shares

The source rule is payment by a Czech person or a domestic PE. For interest on limited liability companies or cooperatives another criterion has to be met: the seat of the entity has to be in the Czech Republic.

3.1.11. Other capital gains (i.e. from the sale of immovable property, intangibles)

The source rule is a combination of two aspects: payment by a Czech person or a domestic PE; as regards movable property, it has to pertain to a domestic PE; as regards intangibles, they have to be registered in the Czech Republic.

3.1.12. Pensions and alimony

The source rule is payment by a Czech person or a domestic PE.

3.1.13. Directors' fees

The source rule is payment by a Czech person or a domestic PE.

3.1.14. Expenses and tax havens

For PEs and capital gains Czech law allows income earned by a foreign company to be taxed on a net basis. There are no special rules as regards tax-deductible expenses for non-resident taxpayers. There are no restrictions for payment abroad and all taxpayers are in the same position from the perspective of the law. However, in practice in some situations it is difficult to determine connected expenses of a foreign entity, either because the entity is not obliged to register in the Czech Republic and keep accounts there (the case of capital gains), or in the case of PEs when they are allowed to deduct part of the general expenses of a foreign company attributable to it. The bylaw includes only an explanation that the expenses of a PE also include part of the general administrative expenses incurred abroad for achieving income in the Czech Republic.

Czech law does not contain any special provision providing for a different treatment of income earned by residents of tax havens, or residents who are not subject to tax on income. The law includes only a general "substance-over-form" clause and a rule stating that for determining the base the accounts should apply except when the taxpayer evades tax. Czech law does not recognise the concept of "tax haven" and does not include any blacklist of countries that are generally considered tax havens.

3.1.15. Personal allowances

The basic personal allowance is available for all taxpayers irrespective of their residence. Other allowances for a certain family status or health ability status have to be proved by the taxpayer and are available only for residents. The only exception is for taxpayers who are resident in another EU Member State and who earn at least 90 per cent of their worldwide income in the Czech Republic. In such cases they can also claim these other allowances starting from 2004.

4. Coordination of residence and source taxation

Table 2 indicates the current tax treaty policy of the Czech Republic, based on recent Czech treaties.

4.1. Tax-sparing clause

The current treaty policy of the Czech Republic is to negotiate the credit method for elimination of double taxation. This can be seen as a step towards the preven-

Type of income	A. Follows the OECD model convention	B. Tries to obtain more residence taxation rights than are provided in OECD model	C. Tries to obtain more source taxation rights than are provided in OECD model
Business profits (excluding services) attributable to a local PE			X ^a
Business profits (excluding services) not attributable to a local PE	X		
Dividends paid to a foreign parent	X		
Dividends paid to a foreign portfolio shareholder	X		
Independent services rendered by professionals and consultants	X		
Independent services by artistes and athletes	X		
Other types of independent services	X		
Employment income			X ^b
Shipping and air transport income	X		
Rental payments for immovable property	X		
Interest		X ^c	
Rental payments for equipment (not a financial lease)			X ^d
Royalties			X ^e
Capital gains on shares	X		

Table 2. (cont.)

Type of income	A. Follows the OECD model convention	B. Tries to obtain more residence taxation rights than are provided in OECD model	C. Tries to obtain more source taxation rights than are provided in OECD model
Other capital gains	X		
Pensions	X		

^a The Czech Republic started to include a wider definition of PE in its treaties from 1994. A PE is also deemed to arise when services are provided in the territory of the other state for a certain period even if there is no fixed place of business.

^b The Czech Republic started to depart from the "presence test" for counting of 183 days in 1997. Since then the Czech Republic has tried to include a wider concept of counting the period of inclusive days spent outside the country when the employee resumes work in the source country. Fourteen tax treaties include this special rule.

^c The Czech Republic is willing to agree to sole residence taxation; 29 tax treaties out of 66 contain a rule according to which interest may be taxed only in the country of residence.

^d The Czech Republic has always intended to tax payments for the use of equipment by way of a withholding tax within the article on royalties. In this respect a reservation is formulated to the OECD model convention.

^e Since 1996 the Czech Republic has been insisting on taxation of all types of royalties at a rate of 10 per cent. In the older treaties concluded in the 1970s and 1980s payments for copyright were exempt from source taxation, while payments for industrial royalties were subject mostly to a 5 per cent rate.

tion of double non-taxation and achieving an equitable approach to all resident taxpayers. In the past the Czech Republic was willing to grant a tax-sparing clause when this was requested. Such a clause may be found in 18 treaties (to name the European ones: Albania, Cyprus, Denmark, Greece, Latvia, Lithuania, Malta, Poland). It seems that the Czech Republic has now departed from this approach, as can be seen from the renegotiated treaty with Slovakia (2003), which no longer contains this provision.

4.2. Double tax relief

As stated above, the Czech Republic abolished unilateral relief in 2002. This means that the rules in double tax treaties are always more generous. Nevertheless the law includes a definition of the credit and exemption methods and means of calculation and then refers to double tax treaties. As regards the credit method, an ordinary credit with per country limitation is used. Excess credit is tax deductible in the following taxable year. As regards the exemption method, both full exemption (for corporations) and exemption with progression (for individuals) are applied. Foreign losses in the case of the exemption method are disregarded.

If the foreign income of a PE located in the Czech Republic is taxable therein the Czech Republic's treaties do not provide relief for the double taxation of the PE's income that would arise if the income were taxed in the other country. This

lack of relief has recently been discussed by experts and has also been the subject of discussions with the Ministry of Finance. The experts from the Chamber of Tax Advisors are using cases taken before the ECJ (*Avoir fiscal* 270/83, *Commerzbank* 330/91 and *Compagnie de Saint-Gobain* C-307/97) and persuading the Ministry to prepare legislative change removing this disadvantage.

Appendix

The characterisation of the PE concept in Czech double tax treaties does not follow the usual rules of the OECD model convention. The Czech Republic included a reservation in the model convention stating that, "whilst agreeing with the 'fixed place of business' requirement of paragraph 1, the Czech Republic reserves the right to propose in bilateral negotiations specific provisions clarifying the application of this principle to arrangements for the performance of services over a substantial period of time". In its current treaties the Czech Republic insists on having paragraph 3 of article 5 in the following wording:

"The term 'permanent establishment' likewise encompasses: (a) a building site or a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than twelve months; (b) the furnishing of services, including consultancy or managerial services, by an enterprise of a Contracting State through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue in the territory of the other Contracting State for a period or periods exceeding in the aggregate six months within any twelve month period."

The provision on taxation of services started to be included in the treaties since 1994. The efforts of the Ministry of Finance and the tax administration to interpret the older treaties concluded by the Czech Republic which do not include such provisions, in such a way that only the aspect of time could create a place of business, have been criticised for years. One court decision (Regional court Plzen, No. 30 Ca 41/95) clearly supported these critical voices and without any doubt stated that the tax administration could not interpret the concept of PE according to domestic rules (the time test), because double tax treaties had their own definition which took precedence over the domestic one.

Thin capitalisation rules in the Czech Republic cover all domestic as well as cross-border transactions. If the debt/equity ratio is exceeded the excess interest is not tax deductible for the payor, regardless of whether the creditor is a domestic company or a foreign company. Nevertheless there is a difference between domestic and cross-border transactions: if the creditor is a foreign associate company then the payment might be reclassified as dividends and taxed accordingly. This could be regarded as discriminatory. However, in the case of EU creditors the Ministry of Finance expressed its view that the Parent-Subsidiary regime will also apply to these reclassified dividends, and therefore they will be tax exempt.

Résumé

Le système d'impôt sur le revenu adopté par la République tchèque ne constitue pas une exception parmi les systèmes d'impôt sur le revenu adoptés par d'autres pays. Il utilise les deux principes – résidence et source – comme base d'imposition sur le revenu. Que l'on se place du point de vue de la législation interne ou de la réglementation conventionnelle actuelle, la conclusion est que la politique de la République tchèque en matière de conventions consiste à obtenir un volume de retenue à la source légèrement supérieur à celui qui est généralement attribué par le modèle de convention de l'OCDE. C'est ce qui ressort de l'article sur l'"établissement stable" et de l'article sur les "redevances" contenus dans les conventions conclues par la République tchèque.

La législation tchèque n'a pas prévu de définition de la source de revenus étrangère. Les résidents fiscaux tchèques sont assujettis à l'impôt mondial, alors que la loi omet de spécifier des catégories particulières de revenus. La législation tchèque ne prévoit pas de mesure unilatérale visant à l'élimination de la double imposition. La méthode d'imputation et la méthode d'exemption ne sont utilisées que sur la base des conventions de double imposition. Dans le cas de pays non parties à une convention et d'établissements stables internes d'un pays quelconque, la seule méthode utilisable susceptible de remédier à la double imposition est la méthode de déduction. Les conventions de double imposition offrent donc un traitement plus généreux. L'approche conventionnelle vise à utiliser la méthode d'imputation pour tous les types de revenus.

Malgré la source étrangère des revenus des résidents, la source nationale des revenus des non-résidents est définie dans la loi. Une disposition spéciale sur la source comprend une liste systématique des catégories particulières de revenus. L'impôt sur les revenus internes des non-résidents est recouvré par voie de retenue à la source définitive ou par voie d'imposition. La retenue à la source est perçue sur le revenu brut payé alors que, en cas d'imposition, le contribuable est autorisé à déduire les frais corrélés. Les règles qui régissent la déclaration des dépenses déductibles de l'impôt sont identiques pour les contribuables résidents et non-résidents.

Zusammenfassung

Die Einkommensbesteuerung in der tschechischen Republik bildet keine Ausnahme im Vergleich zu den Steuersystemen anderer Länder. Als Grundlage für die Einkommensteuer werden beide Konzepte – Ansässigkeit und Quelle – herangezogen. Aus der Sicht des inländischen Rechts und der gegenwärtig geltenden Besteuerungsabkommen lässt sich erkennen, dass die Abkommenspolitik der tschechischen Republik etwas mehr zur Quellenbesteuerung tendiert als generell durch das OECD-Musterabkommen empfohlen. Das lässt sich anhand der beiden Artikel "Ständige Niederlassung" und "Lizenzgebühren" der DBAs darstellen.

Das tschechische Recht enthält keine Definition von Einkommen aus ausländischer Quelle. Steueransässige unterliegen der Steuer mit ihrem Welteinkommen, dabei spezifiziert das Steuerrecht keine besonderen Einkommensarten. Eine einseitige Befreiung zur Vermeidung der Doppelbesteuerung kennt das tschechische Recht jedoch nicht. Das Anrechnungsverfahren und das Befreiungsverfahren gelten nur auf der Grundlage eines DBA. Bei Ländern, mit denen kein Abkommen besteht, und bei inländischen ständigen Niederlassungen kann Doppelbesteuerung nur durch das Abzugsverfahren umgangen werden. Doppelbesteuerungsabkommen bieten daher eine grosszügigere Behandlung. Durch solche Abkommen soll das Anrechnungsverfahren für alle Einkommensarten ermöglicht werden.

Das Steuerrecht enthält jedoch eine Definition für inländische Einkünfte bei Nichtansässigen. Zur Bestimmung der Quelle besteht eine Liste für die Besteuerung besonderer

Einkommenskategorien. Die Besteuerung auf inländische Einkünfte von Nichtansässigen wird durch Einbehaltung oder durch Veranlagung bestimmt. Quellensteuer wird auf das Bruttoeinkommen erhoben, während es dem Steuerzahler bei der Veranlagung gestattet ist, die mit diesem Einkommen verbundenen Ausgaben in Abzug zu bringen. Die Vorschriften über die Anwendung der abzugsfähigen Ausgaben sind identisch für ansässige und nichtansässige Steuerpflichtige.

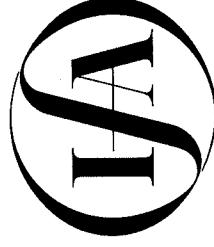
Resumen

El régimen del impuesto sobre la renta de la República Checa no constituye excepción entre los adoptados por otros países. Utiliza los dos principios – residencia y fuente – como base en la imposición sobre la renta. Tanto desde la perspectiva de la legislación interna como desde la de la vigente normativa convencional, la conclusión es que la política de la República Checa en materia de convenios es obtener una cifra de retención en la fuente ligeramente superior a la contemplada generalmente por el modelo de convenio de la OCDE, hecho que demuestran los artículos sobre “establecimiento permanente” y “cánones” de los convenios que ha concluido.

La legislación checa no define la fuente de renta extranjera. Los residentes fiscales checos tributan por su renta mundial, si bien la ley no especifica las categorías de renta. Tampoco prevé medidas unilaterales para eliminar la doble imposición. Los métodos de imputación y exención sólo se aplican en base a convenios de doble imposición. El método de deducción es el único aplicable para evitar la doble imposición a países no partes de un convenio y a establecimientos permanentes internos de cualquier país. Así pues, los CDI ofrecen un trato más generoso. El enfoque convencional trata de aplicar el método de imputación a todos los tipos de renta.

A pesar de la fuente extranjera de las rentas de residentes, la fuente nacional de las rentas de los no residentes se define en la ley. Una disposición especial sobre la fuente comprende una lista sistemática de las categorías de rentas. El impuesto sobre las rentas interinas de los no residentes se recauda vía retención en la fuente definitiva o vía imposición. La retención en la fuente se practica sobre la renta bruta pagada, mientras que en la imposición el contribuyente puede deducir los gastos producidos. Las normas sobre declaración de los gastos deducibles del impuesto son idénticas para contribuyentes residentes o no residentes.

cahiers de droit fiscal international



Volume 90a

Off-print

Source and residence:
new configuration of their principles