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MODIFIED AREA-BASED SYSTEM IN CZECH REPUBLIC

Abstract

Tax system in the Czech Republic and offers some specific suggestions for reform. In the long term, their taxation could be maintained. Many politicians not only in the Czech Republic believe that a higher property tax on real estate investments can solve the housing crisis. There are several examples showing that such a solution does not lead to the desired result. In many states, such a tax increase solved a certain "housing crisis". Such a solution is at all sensible and will ultimately not only disadvantage economically the socially weaker, who do not have the resources to get their own place. On the other hand, the overall taxation of investment housing could contribute to increasing revenues of municipal budgets without changing the budgetary allocation of taxes. The inclusion of elements of elementary equality and work with so-called local coefficients, possibly combined with the categorisation of immovable property as established in the Land Registry, appears to be a meaningful key to the solution. On the basis of these two groups or categories, differential taxation can be achieved for a wide range of properties without creating room for discussion about what is and is not an investment apartment [OECD 2010]. But there are two weaknesses in dealing with this, namely policy changes, where the increase in the coefficient is unpopular within local authorities, and that it will be quite different in this area. The area-based property tax has been gaining influence in developing and transitional countries

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around the world. This report first examines how the area-based tax is administered in thirty-eight countries according to statutes. Area-based assessment is more commonly used in rural areas than urban areas, for land than buildings, and with few adjustments. Over half the countries allow some local control [Fischel 2001: 17].

The paper presents an overview of the theoretical and practical experience of both the immovable property taxation forms (area-based and value-based) concerning the different aspects of micro and macroefficiency, equity and the “ability to pay” aspects as well as the fiscal and technical aspects, with the special emphasis on (post)transition economies – new EU members. The EU recommendations in this area, especially concerning the shift of tax burden from (labour) income to property, are pointed out. The comparative analysis of relevant taxation in the EU member countries is presented, pointing out that some of them, which have fulfilled the formal requirement of the recurrent taxes on immovable property introduction, still implement a simpler form – the area-based one.

In particular, the article focuses on the definition of the tax system in the Czech Republic, and intentionally on the processing of property taxes. Inheritance, gift and acquisition taxes on immovable property, including their definition and the way in which they are transformed, are mentioned in particular in these property taxes. However, the main objective of the work was to approximate the property tax, in relation to value-based taxation or a modified area-based system. Attention is also focused on defining the pluses and minuses of these taxes, what advantages they are, what advantages they are not, and which of the countries uses which system of taxation. The work seeks to highlight why a system is used within the Czech Republic, including its benefits within the tax system.

Keywords: recurrent taxes on immovable property, value-based taxation, area-based taxation, user charges, property taxation.

JEL Classification: K34.

1. Introduction. Tax System in Czech Republic

The tax system in the Czech lands during Middle Ages developed similarly as in other European countries. The tax collecting was fully in the power of the reigning monarch. During the reign of Charles IV, there were many possible tax reliefs, for example not paying any taxes from newly established vineyards for a period of twelve years [Bahl 2004]. But there were also a special tax for Jewish minority. They had to pay an annual fee which was almost twice as high as the tax for the rest of the population for using land and protection from the king. In 1546, there was implemented a tax from selling

beer. This tax kept increasing till the end of 16th century [Bronchi, Burns 2011]. During the Austrian Empire in the 18th and 19th centuries, the Bohemian Kingdom (what is now the Czech Republic) carried a significant part of the tax burden, as one of the most industrialized parts of the empire, paying 32% of all taxes in the Austrian territories in 1750. Since the break with the Soviet Union, multiple reforms have been done to bring the economy from a government run economy to a free market economy [Franzsen 2016]. This also brought a long range of tax reforms, including the introduction of a flat tax, and shift from direct taxes over to indirect taxes and large amounts of tax simplifications. In 1990, the Czech Republic introduced a long range of environmental charges, including air emission charges, CFC product charges, water extraction and pollution charges, sewage charges, charges for waste disposal, land conversion charges, and an airport noise tax.

The current tax system in the Czech Republic was established in 1993. Taxes are divided into 3 basic groups – direct taxes, indirect taxes and other taxes. Since EU accession on 1 May 2004, the system has undergone a continuous process of harmonization with European legislation [Radvan 2015]. The Czech Republic also has a broad network of double taxation treaties with both EU and non-EU countries. These double taxation treaties are based mainly on the OECD Model Tax Convention [OECD Library]. Direct taxes consist of: Personal income and corporate income taxes governed by the Czech Income Taxes Act, Property taxes governed by the Czech Real Estate Tax Act and Act on Road Tax and Transfer taxes governed by the Czech Act on Real Estate Acquisition Tax. The Czech tax system consists of direct and indirect taxes. Direct taxes include income tax (both corporate and personal), road tax, real estate and real estate transfer tax, inheritance tax and gift tax. In between indirect taxes belong value added tax (VAT), duties, ecotaxes and excise taxes [Radvan 2020].

2. Property Tax in Czech Republic

In addition, property taxes may include road tax, which for the purposes of the chapter will be mentioned only in relation to the jointly applicable provisions to the taxes in question. It should be noted, however, that property taxes until recently included the tax on the acquisition of immovable property [Radvan 2020]. On 26. 9. 2020 was based on the effectiveness of Law No. 386/2020 Coll. repealing Senate Legislative Measure No. 340/2013 Coll., on the tax on the acquisition of immovable property, as amended,

and amending and repealing other related legislation, to abolish the tax on the acquisition of immovable property in subsequent cases.

The issue of inheritance, gift and real estate transfer tax was regulated by Act No. 357/1992 Coll. until the end of 2013. In connection with the reconfiguration of private law, the original law was No. 357/1992 Coll. on 31 December 2013 repealed and replaced by Senate Legislative Measure No. 340/2013 Coll., on the tax on the acquisition of immovable property, and the Senate's duplicate statutory measure No. 344/2013 Coll. on 1 January 2014 [Radvan, Franzsen, McCluskey, Plimmer 2021]. The original Act No. 357/1992 Coll. of 1992 included all three taxes, which were included in the direct property tax, therefore they were often referred to together by the collective term tri-tax. Both inheritance tax and gift tax have been formally abolished, but both gifts and inheritances are subject to personal income tax or corporation tax. Inheritance tax has been abolished entirely, inheritance is newly perceived as acquisition free of charge and is under Section 4a of Act No. 586/1992 Coll. on Income Taxes Exempt from Income Tax. Donations are rebranded as gratuitous income and are classified under the category of "other income" § 10 of Act No. 586/1992 Coll. on income taxes. The subject of inheritance tax is the acquisition of immovable and movable property by inheritance by will or by law [Bahl 2017]. In the case of movable property, the nationality and permanent residence of the deceased on the day of his death are key elements in determining the subject-matter of inheritance tax. If, at the time of his death, the deceased was a citizen of the Czech Republic and resident in the Czech Republic, tax is levied on all his movable assets, regardless of whether they are located in the Czech Republic or abroad, in the remaining cases the tax applies only to the deceased's movable assets in the Czech Republic. The tax is levied on properties located in the Czech Republic irrespective of the nationality or residence of the deceased; no tax is levied on properties located abroad [Radvan 2017].

The rate of inheritance tax depends on the relationship with the testator and the value of the inherited estate. The tax is based on the price of the assets acquired by the individual heir, less proven debts of the deceased passed on to the heir by the deceased's death, costs associated with the funeral of the deceased, or expenses for the services of a notary connected with the succession. Inheritance tax was abolished on 31 December 2013, inheritance is newly perceived as acquisition free of charge and is under Section 4a of Act No. 586/1992 Coll. on Income Taxes Exempt from Income Tax.

The taxpayer of the gift tax is always the donor in the case of the free supply of property to a natural or legal person who is not resident in the country (or not resident in the country).

In other cases, the taxpayer is the donor acquirer, i.e. the one who received the property free of charge and the donor the guarantor. The subject of gift tax is the acquisition of property free of charge on the basis of a legal act, or in connection with a legal act. The basis of the gift tax is the price of the property, less any proven debts or duties paid on importation in the case of movable goods donated or imported from abroad.

The tax on the acquisition of immovable property is abolished in all cases where the legal effects of the land registry deposit arise on 26.9.2020 and later. Furthermore, under the transitional provisions, the abolition of the tax on the acquisition of immovable property applies to those cases in respect of which the deadline for submitting a tax return has expired from 31 March 2020, that is to say, those cases of deposit of the right in the Land Registry which took place in December 2019 and later, or in that month or in subsequent months, the acquisition of ownership of the immovable property which is not registered in the Land Registr, and thus expired on 31st December 2020 and later [Financial Administration 2020]. However, in order to approximate the tax at least in part, it is necessary to define their structural elements. The acquisition tax was always paid by the acquirer (usually the purchaser). This was a one-off tax paid after the acquisition of the property. The purchaser of the title (generally the purchaser) of the items filed the tax return on the acquisition of the immovable property no later than the end of the third month following that in which the right was registered in the Land Registry. The Act lists specific cases where different procedures have been followed [Financial Administration 2020].

The tax on the acquisition of immovable property concerned only transfers of immovable property for consideration, not inheritances or gifts. The subject-matter of that tax was the acquisition for pecuniary interest in an immovable property which is a land, building or unit situated in the territory of the Czech Republic, a building right by which the encumbered land is situated in the territory of the Czech Republic, or a part-ownership interest in the immovable property referred to in the preceding paragraphs. However, the subject-matter of the tax on the acquisition of immovable property was not the acquisition of title to the immovable property by making land improvements, conversions by commercial corporations, or provided as compensation for expropriation. In those cases, the taxpayer was not obliged to submit a tax return.

Another important structural element of this gave was the determination of its basis. The tax base on the acquisition of immovable property has been determined on the basis of the acquisition value less eligible expenditure [Radvan, Kranecová 2021]. The acquisition value may have been the agreed price, the comparative tax value or the price determined. Primarily, the acquisition value was the agreed purchase price for the property in question.

The rate of the tax thus determined was in any event percentage-linear. If it was a comparative tax value, this was a fictitious amount equivalent to three-quarters of the guide value or the price found. It was then up to the taxpayer to decide on the value or the price determined. There was often a special price. This was used for auctions, for commercial corporations in connection with insolvency proceedings, in connection with probate proceedings, etc.

The tax rate on the acquisition of immovable property was 4 %. The tax on the acquisition of immovable property was thus calculated as 4% of the tax base, rounded up to the full 100 crowns. The tax base could be the purchase price or 75% of the guide value (the usual price determined by the tax office). The tax on the acquisition of immovable property was paid on filing the tax return as an advance [Radvan, Kranecová 2021]. The tax office calculated the tax and compared it with the advance paid. The tax supplement on the acquisition of immovable property (tax is higher than the advance) was payable within 30 days of receipt of the notice of payment. A tax supplement of less than 200 CZK was not paid, while a tax on the acquisition of immovable property of less than 200 CZK was not paid. The details, exceptions and detailed procedure for filing the tax return were set out in the Tax Act on the acquisition of immovable property and described in the guidelines for completing the tax return on the acquisition of immovable property.

The taxable period is a calendar year. The real estate tax return must be filed with the tax authority within whose boundaries the property is located, by 31 January of the first taxable period. In the following years a real estate tax return does not need to be submitted if no change in the property occurs or there is a change of tax rates or other parameters under the real estate tax legislation.

3. Value-based Taxation

A value-based system of property taxation is possible if regular re-evaluations are introduced and the tax value is determined as close to the real value of the asset as possible. However, this has proved to be a problem in many countries that have opted for ad valorem taxation [Franzsen 2016]. Such a system must be viewed from two sides, both by the taxpayer and by the tax authority – the State. Like any change, there would be upsides and downsides to any change to the value system. The very existence of real estate taxation is absolutely necessary and tax-equitable. The Czech Republic has long had some of the lowest real estate tax revenues in the entire European Union. I see one of the main problems with the transition to ad valorem taxation in the established tax base. Despite the fact that the

Czech Republic is trying to move to a value-based method for its determination in the case of soil, no change is yet planned in the area of buildings [Radvan, Papavasilevská 2021]. In the case of land, each year, its creditworthiness is determined by the relevant decree of the Ministry of Agriculture for each land registry. As the percentage linear rate of tax is determined for the calculation of the tax instead of the fixed rate in the case of buildings, we see some issues in the transition. The tax base should always be determined by the value of the assets identified from the contracts that form an annex to, for example, a land registry deposit. If the amount could not be ascertained, it would be determined by the price of similar properties in the locality [Franzsen 2016]. The transition to ad valorem taxation itself, regardless of the fact that it would currently be more favourable, is far from simple especially for the divergence between Czech and European legal regulation, which differs significantly in many ways. The value-based system of taxation of immovable property currently has a large presence and is worldwide. Such a system is, for example, common to the US. Efforts to choose an ad valorem system were already made within the Czech Republic in 2012. The draft law, drafted by the Ministry of Finance of the Czech Republic, provided for ad valorem taxation only for land in areas that are or could be built up [Radvan 2015].

4. Modified Area-based System

As obvious from the international literature sum up in the Franzsen's presentation (2016), the area-based system is used primarily in developing countries, in Europe especially in Central and Eastern European Countries. In case of buildings and apartments, it might be based on the built-up area or carpet (habitable) area. Most of the countries modifies the original area-based system according to their economic and political needs or with regard to the regulation in related legal areas. E.g., Czech tax base for apartments is the adjusted floor area, which covers not only the total floor area of the flat, but the related common areas of the house and land related to the house. Most of the modifications in the Czech property tax regulation is hidden in the tax rate structure. E.g., the location rent following the number of inhabitants (at least partially) reflects the value as the property situated in big cities usually has a higher value compared to the property in the rural area. The business property generally has a higher value than the residential property and that is why the basic tax rate is higher for houses and apartments used for business. Area-based system, especially if it is modified in a reasonable way, might be a perfect solution for countries where the political will to substantially increase the property tax is missing. This system is pretty cheap, especially if the cadaster (property register) is complete and accurate. The tax office, having a direct access to the cadaster, is able to assess the tax without asking the taxpayer to file

the tax return. Only in case of uncertainty, there must be a possibility to make the situation clear: the tax office may use online tools (geographic maps, online maps, street view, etc. or contact the taxpayer).

5. Pros and cons of area-based property tax

5.1.Pros

An area-based property tax has certain advantages over a value-based system. An area-based system (1) scores well in terms of revenue stability and predictability; (2) may be simpler to administer than a value-based property tax system by requiring only area measurements, and eliminating the need for costly collection and analysis of market data and revaluations; and (3) may be equitable in terms of an individual's tax burden in proportion to the amount of benefit received from the property. In addition, the measurement of area is more objective than estimations of property market value because assessors make judgments about comparable properties when estimating market value [Youngman, 2016].

5.2.Cons

One disadvantage of an area-based system is its inability to generate adequate revenues to fund locally provided goods and services compared to a market value-based property tax. A value-based property tax also scores better on ability-to-pay equity grounds [OECD Library]. An area-based assessment results in a relatively greater burden on low-income taxpayers than high-income taxpayers when compared to value-based assessment. This is because average household incomes in high-value neighbourhoods are higher than in low-value neighbourhoods. Finally, an area based system taxes all properties that are the same size equally, regardless of whether they are in high-income or low-income neighbourhoods.

6. Conclusion

The literature analysis of the pros and cons of the area-based and value-based recurrent immovable property taxation reveals a superiority of the area-based assessments concerning the administrative costs and the (un)popularity among taxpayers, while the value-based taxation seems to be superior concerning most of the remaining criteria (efficiency, equity and ability to pay principle, fiscal aspects and growth) and especially the fiscal decentralization. However, the benefits of the area-based assessment are particularly important for the small (post)transition and developing countries and some benefits of the

value-based taxation could be achieved also with the area-based assessments, but at a smaller scope. Earmarking is an additional drawback of the area-based user charges (not “real” taxes). The comparative analysis of the new EU member states reveals that most of them still apply the area-based taxation. Although they also yield relatively significant fiscal results, it seems that the potential for a desirable tax shifting (toward those taxes) is higher with the value-based taxation in the long run. However, they could be avoided in the first stage of this process by a simple transformation of the existing communal charge (utility fee) into the simple immovable property tax. This tax could still be the area-based in principle, but with an improved inclusion of the property location and its purpose. The unchanged tax burden in the short run accompanied by the exclusion of earmarking, would offer a greater scope of the fiscal decentralization.

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