Czech Republic

Changes to the calculation of the tax base and the operation of payroll withholding for non-residents

Executive summary
On 4 December 2018 the Czech Parliament approved changes which impact the calculation of total taxable income for individuals assigned to the Czech Republic, but who remain in their home country’s social security system. Rather than using a hypothetical employer’s contribution rate based on what would be payable under the Czech social security system, the actual mandatory employer’s contributions in the home country are now used. This only applies to assignees affiliated to Swiss, EU and EEA member states mandatory social security schemes.

The Czech tax authorities have also changed their approach to payroll withholding for non-residents working in the Czech Republic and Czech resident individuals assigned to their employer’s permanent establishment situated abroad. Employers will now have to calculate the Czech taxable portion of the individual’s pay on a month by month basis. This is significant change from the previous approach of operating full withholding while reconciling the position via the tax return.

Both of these changes will have a significant impact on payroll operations in the Czech Republic for inbound international assignees and assignment tax costs.

Changes to the tax base for assignees
On 4 December 2018 the Czech Parliament unexpectedly approved an amendment of the Czech Income Tax Act. Previously, the tax base for employment income was calculated as the sum of the gross income and mandatory employer Czech social security and health insurance contributions.

For those who remain in a non-Czech mandatory social security system, the hypothetical Czech contributions were used for the tax base calculation. As a result, the Czech tax burden of those subject to Czech and foreign social security systems was the same.

Following the amendment, from 1 January 2019, the Czech employment income tax base of employees who are demonstrably insured in another EU/EEA member state or in Switzerland, will be calculated as gross income increased by the actual amount of the employer’s mandatory social security and health insurance paid in the respective EU/EEA country or Switzerland, not by the hypothetical amounts of the Czech employer contributions. The change affects both the annual tax liability and monthly payroll tax calculations. The respective A1 certificate should be available.

The change does not apply to employees subject to foreign social security systems who are not insured in another EU/EEA country or Switzerland. Their gross income for the purpose of calculating the tax base will continue to be increased by hypothetical employer’s contributions to the Czech mandatory social security and health insurance scheme.

Given the changes to the calculation of the tax base, the effective tax rate for employment income will therefore vary significantly depending on social security scheme which the employee is covered by.

Changes to the operation of payroll withholding for non-Czech tax resident assignees
The Czech tax authorities have recently confirmed their approach to the calculation of monthly payroll tax withholdings for employees who are regarded Czech tax non-residents. This change is not based on any amendment to the law, but is a revision of the Czech tax authorities approach to this.
In the past, the Czech withholdings were generally calculated based on the entire income of non-residents. The income taxable in the Czech Republic was subsequently calculated on the employee’s annual tax return. Payroll withholdings related to income for work performed outside the Czech Republic was refunded by the tax authorities without any particular delays, based on the filed tax return.

This was a relatively straightforward approach given the complexity of the tax residency rules and double tax treaties and the difficulties for employers in assessing the tax residency status of their employees and proving their tax residency position.

The Czech tax authorities now require employers to calculate income taxable in the Czech Republic through payroll on a monthly basis. For non-residents, the employer should calculate and remit the monthly payroll tax withholdings based solely on income taxable in the Czech Republic (income related to workdays in the Czech Republic).

Where the correct allocation cannot be done on a monthly basis, such as where the individual’s residence status is not clear during the year, the allocation has to be performed via a payroll agenda amendment after the end of the respective year. This must be done within the normal deadline for performing the annual payroll tax reconciliation (20 March if the form is submitted in electronic format). However, the employer is still required to be able to prove the residence position of the employee without any doubts.

The same approach should be applied for Czech tax resident employees, who are working abroad and whose income is fully or partially allocated to the employer’s permanent establishment registered abroad.

As a result of the revised approach, tax non-residents may have difficulties claiming a refund of overpaid tax via their annual tax return if their employer did not make the Czech source income calculation via payroll. In such a case, the Czech tax authorities may recommend that the employees files a complaint against their employer to require remediation of the payroll calculation. However, such requirements will have a significant impact on the employee’s payroll processing.

**Next steps**

Employers should review their cost estimates and equalisation policies for assignments to the Czech Republic in light of the changes to the calculation of the tax base for assignees insured in Switzerland, EU and EEA member states.

In respect of the changes to payroll withholding, employers will need to balance the risk of a potential incorrect assessment of the tax residency position of individual employees, as well as the allocation of taxable income, with the potential difficulties involved in claiming tax refunds through Czech personal income tax returns.