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Entrepreneur's Tax Records

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Introduction

In the year when the Czech Republic joined the European Union and in the following years, the legislation on individuals (entrepreneurs) who kept books in the system of single entry bookkeeping by the end of 2003 changed. The abandoning of single entry bookkeeping was the basic and most significant change in 2004 and the related amendment to Bookkeeping Act 563/1991 Coll. and Income Tax Act 586/1992 Coll.

1 Legislative Changes for Individuals in Bookkeeping

The amendment to the Bookkeeping Act cancelled the provisions on the systems of double and single entry bookkeeping and stipulated that it is possible to keep books only in the system of double entries as of 1 January 2004. This change is directly related with the harmonisation of Czech law with the law of the European Union. *Due to the cessation of the existence of the single entry bookkeeping*, the previous division of bookkeeping into single entry bookkeeping and double entry bookkeeping does not longer make sense, *therefore, the "bookkeeping" mentioned in legislation since 1 January 2004 has been always understood as double entry bookkeeping.*

The single entry bookkeeping in the Czech Republic was based on the recording of income, expenses and corporate assets and played an important role in the restoration of private business after November 1989, particularly when determining income tax base for individuals. The entrepreneurs who kept books in the system of single entry bookkeeping by the end of 2003 had to check, in compliance with the amendment to the law, whether they did not become a unit of account and whether they are obliged to keep (double entry) bookkeeping or whether they can keep so called **tax records**, which replaced the single-entry bookkeeping. At the same time, the entrepreneurs – individuals – have to check regularly now whether they can keep tax records or whether they fulfil conditions for the origin of a unit of account.

1.1 Tax Records

Tax records should enable income tax payers to record income and expenses in a simpler way. The transition from single entry bookkeeping to tax records did not bring any extraordinary burden for tax payers because the principles of single-entry bookkeeping and tax records are similar from tax aspect. Tax records are **provided in Income Tax Act 586/1992 Coll.**, as amended. **Tax records can be kept by the following individuals** (entrepreneurs):

- individuals *unless they are recorded in the Commercial Register;*

- individuals *unless they decide to keep books voluntarily*;
- individuals *unless they are a part of an association* without legal subjectivity in which there is at least one participant who is a unit of account;
- individuals whose *turnover, defined by Value-Added Tax Act, did not exceed CZK 25 mil. for the previous taxation period.*

The amount of the turnover, which is one of the criteria whether the entrepreneur can keep tax records or must keep books, was newly stipulated on CZK 25 mil. as of 1 January 2008, whereas the previous amendments stipulated the limit of CZK 15 mil. as of 1 January 2005. The original amendment stipulated the turnover of CZK 6 mil.

1.2 Objective of Tax Records

The objective of tax records is defined in *Section 7b of Income Tax Act. The income tax base in compliance with Section 23* of this act is the difference, by which the income, except for the income which is not the subject to taxation and income exempted from taxation, exceed expenses (costs), respecting their material and temporal relations in the given taxation period.

The entrepreneur who keeps tax records:

- is obliged to *record all income and expenses relevant for taxes for the taxation period*;
- is obliged to keep records so that he is able to calculate the difference between income and expenses for the previous calendar year, *to prepare tax income return for individuals and to submit it in time*;
- is obliged to *keep records of tangible assets, stock, receivables and payables* at least in such an extent so that he is able to calculate the amount of these assets on the last day of the taxation period.

The mentioned provisions are related to payers (individuals) with income in compliance with Section 7 of the Income Tax Act who *will not keep double entry bookkeeping and will record tax expenses in real amount*. Therefore, they do not relate to those entrepreneurs who apply tax expenses by percentage from income (Section 7 (9) of Income Tax Act) or take advantage to determine the tax by a lump sum (Section 7a of the same act).

1.3 Corporate Assets of an Entrepreneur who Keeps Tax Records

In compliance with Section 4 (4) of Act 438/2003 Coll. (amendment to Income Tax Act), the *corporate assets* for the purposes of income tax of individuals is understood as a set of property values (assets, receivables and other rights and other values that can be evaluated by money), which are in the entrepreneur's ownership and are *kept in records of assets and payables* for the purposes of determining the income tax base (below only „tax records“). The day when an entrepreneur recorded it in tax records is understood as the day of the exclusion of the assets from corporate assets.

As regards the *contents of the individual components of assets in tax records*, bookkeeping rules are used, unless Income Tax Act stipulates otherwise (e. g. for tangible assets). It concerns the following instruments:

- Bookkeeping Act 563/1991 Coll., as amended;
- Regulation 500/2002 Coll. implementing certain provisions of Bookkeeping Act 563/1991 Coll., as amended, for units of account that are entrepreneurs keeping books in the system of double entry bookkeeping, as amended by Regulation 472/2003 Coll.;
- Czech Accountancy Standards for Entrepreneurs, published by the Ministry of Finance of the Czech Republic on 1 January 2004.

2 Contents and Form of Tax Records

Compared to bookkeeping, **neither form nor manner of keeping tax records is stipulated in legislation.** It is the entrepreneur himself who decides about the manner of keeping tax records in a specific company, however, it is essential so that the records are kept in compliance with Section 7b of Income Tax Act. The contents of tax records will depend particularly on the individual components of corporate assets according to the subject and extent of business activities.

In order to ensure the provability of recorded data and, consequently, correct determination of personal income tax base, it is recommended for the entrepreneur to compile an *internal directive* stipulating the exact manner of keeping tax records, both as regards the form and contents.

Tax payers (entrepreneurs-individuals) prove their expenses to achieve, ensure and maintain income with **tax documents**. Tax records are regarded as provable if one can substantiate entries with tax documents and if it is in compliance with the real amount of assets and payables determined by stock-taking at the end of a taxation period.

2.1 Estimation of the Value of Assets and Payables in Tax Records

The following types of prices are used to **estimate values in tax records**:

- **purchase value**, i. e. the price for which assets were acquired and expenses related to their purchase;
- **reproduction purchase price**, i. e. the price for which assets were acquired in the moment when they were entered in tax records;
- **own costs**, which include direct costs expended for the production or another activity and indirect costs that are related to the production or another activity;
- **nominal value**.

2.2 Estimation of the Value of Assets and Payables in a Foreign Currency

A payer having income in compliance with Section 7 that keeps tax records and has *income and expenses in a foreign currency* will use a **single rate of exchange** to estimate the value of assets and payables. The single rate of exchange is determined as the **average of the rate of exchange** stipulated by Czech National Bank on the last day of each month of the taxation period. In case that the tax return is submitted in the course of a taxation period, the rate of exchange of the day when the individual income and expenses are carried out is used or the average of the rate of exchange stipulated by the Czech National Bank on the last day of each month of the taxation period for which the tax return is submitted.

2.3 Tax Records of a VAT Payer

The keeping of tax records is influenced by the fact whether an individual (entrepreneur) is registered as a value-added tax (VAT) payer or not.

The obligation of an existing VAT non-payer to be registered as a VAT payer follows from the provisions of Section 94 (1) of Value Added Tax Act 235/2004 Coll. (“VATA”) if:

- he is a **person obliged to pay the tax** in compliance with Section 5 of VATA (an individual or a legal person that performs an economic activity individually);
- he has **headquarters, a place of business or business premises inland**;
- his **turnover for the nearest 12 previous consequent calendar months exceeds the amount of CZK 1 mil.**

A person obliged to pay the tax is obligated to submit an *application for the registration of a tax payer* to the local financial authority when the determined turnover limit is exceeded by the 15th day after the end of the calendar month in which the turnover limit was exceeded.

A payer can ask for the *cancellation of registration* not earlier than one year after the effective date specified in the registration certificate issued by the financial authority if his turnover did not exceed CZK 1 mil. for the closest previous twelve consequent calendar months.

2.4 Preservation of Tax Records

The provisions of Section 7b (5) of Income Tax Act (“ITA”) stipulates the *obligation to preserve tax records* for all taxation periods for which the period to assess tax laid down by this act or a special regulation, i. e. *at least 3 years and not more than 10 years* from the day when the individual was obligated to submit the tax return, did not finish. In case that the entrepreneur reports loss from business activities, it is necessary to remind the provisions of Section 38r of ITA in compliance with which an audit by the tax administrator is possible even after 10 years (up to the limit of 16 years).

The payer is obligated to preserve all *tax documents decisive for VAT determination* at least *for the period of 10 years* from the end of the taxation period in which the taxable transaction or a transaction exempt from taxation with an entitlement to have taxes deducted on a place determined by him.

The period during which the documents have to be preserved is stipulated not only by tax legislation but also by *legislation in social area*, namely Act 582/1991 Coll., on the organisation and implementation of social security, as amended (“AOISS”), and Act 589/1992 Coll., on social security premium and contribution to national employment policy, as amended (“ASSP”).

The provisions of Section 35a (4) AOISS clearly lays down the period that stipulates the obligation of the entrepreneurs to preserve *payroll sheets* or records on data necessary for the purposes of *pension insurance* for the period of *30 calendar years* following the year that they relate to.

Section 22c of ASSP stipulates the period for insurance payers. This period concern his obligation to preserve records and data necessary to determine and pay insurance premium. The insurance premium payer is obligated to preserve these documents for the period of *10 calendar years* following the year that they relate to.

3 Tax Records of Income and Expenses

Data about income and expenses forms the main part of tax records. Requirements for the *contents* of these records follow from the relevant *provisions of Income Tax Act*, particularly from Sections 23 to 33. As follows from Section 7b of the Income Tax Act, only the records of income and expenses that influence the tax base are relevant for tax records. The recording of non-tax income and expenses is not dealt with and, therefore, it is entirely up to the entrepreneur whether they will form a part of the tax records. The manner of payments (cash or bank account transfers) does not influence the tax base at all.

The records of income and expenses are kept by the entrepreneurs who achieve income from business or another independent earning activity in compliance with Section 7 of Income Tax Act, who are not units of account and who do not apply tax expenses by percentage from income nor take advantage of a so-called lump tax. Compared to single entry bookkeeping, the tax records have to contain data about all taxable income and related expenses relevant for the tax, both in pecuniary and non-pecuniary form.

The contents of the *records of income and expenses* follow from the definition of Income Tax Act 586/1992 Coll., as amended. There is appropriate to compile records in the classification necessary to determine the tax base. Tax records of tax payers – individuals who apply expenses in compliance with Section 24 of Income Tax Act – include all income from business activity and expenses to achieve, ensure and maintain taxable income. This income

and expenses of tax payers – individuals that apply expenses in compliance with Section 24 of Tax Income Act can be included for the calculation of the tax base only in the amount proved by tax documents and at most in the amount stipulated by legislation. This income and expenses can be included in the amount substantiated with tax documents only in the amount proved by tax documents and not in a higher amount than the law stipulates.

Other criteria that follow from related legislation with some entrepreneurs can affect contents of the records of income. For instance, if a personal income tax payer operating a business and other independent earning activity accepts *cash payments* is obligated, besides records laid down by generally binding legal regulations, to keep records of daily sales, unless a tax administrator decides otherwise (provisions of Section 39 (3) of Act 337/1992, on the administration of taxes and fees, as amended).

3.1 Records of Income and Expenses in a Foreign Currency

If an entrepreneur who keeps tax records trades in a foreign currency, he is obligated to keep *records of income and expenses in a respective foreign currency*. He will add up income and expenses separately in Czech and a foreign currency. He will transfer income and expenses in a foreign currency into Czech currency with a single rate of exchange in compliance with Section 38 of Income Tax Act. He will specify total income and expenses in Czech currency in the tax return.

The payer will thus keep *duplicate records of income and expenses* but he will specify income and expenses only in CZK in the tax return.

4 Tax Records of Receivables and Payables

The records of receivables and payables from the entrepreneur towards other entities belong among the entrepreneur's important information without the knowledge of which he cannot determine his tax base correctly and, consequently, prove it and it is also important in case of interruption or termination of his business activity. The records should contain at least data according to which one can identify the contents of a payable or a receivable.

5 Tax Records of Assets

An entrepreneur (individual) monitors long-term assets, leased assets and stock used in his business activities in these records.

The manner of their acquisition, estimation of their value and depreciation must follow from the *records of long-term tangible assets*. One has to mention in this context that *the Income Tax Act was significantly amended* as of 1 January 2005. This amendment concerns *tax depreciation of long-term assets* used to express gradual wear and tear of these assets in tax records. There were other amendments during the next years. The amendments concerned, particularly, the number of depreciation groups, the possibility to increase depreciation in the first year of depreciation with first owners of assets by 10, 20 or 30 %.

The methods of even and accelerated depreciation are used to calculate tax depreciation when respecting the main principle that the assets can be depreciated not more than by the amount of their entry price (or entry price increased by technical improvement).

At the end of the year, one has to record these non-pecuniary expenses in the *records of long-term tangible assets* and to transfer only the adequate part of the entry price in the tax expenses in the form of depreciation. The situation in case of *long-term intangible assets* is simpler because the individuals who keep tax records are regarded, in compliance with Section 24 (2) (zn) of Income Tax Act, as tax expenses for the acquisition of intangible assets or their technical improvement, consequently, there is no adjustment with these assets.

If tangible assets are liquidated in the course of a taxation period, one has to settle their net book value as regards taxes, in compliance with Section 24 (2) (b) and (c) of Income Tax Act.

The net book value of the tangible assets is a tax expense only in case when they are sold or liquidated. If tangible assets are liquidated as a consequence of damage, the net book value is a tax expense only by the limit of accepted compensation. If the damage is caused by natural disaster or by an unknown offender (if confirmed by the police), then the entire net book value is a tax expense. In compliance with Section 26 (7) of Income Tax Act, one can apply one half of the annual depreciation in the tax period when the tangible assets are liquidated.

Leasing of long-term assets is the only possibility for certain entrepreneurs how to acquire property needed for the performance of their business activities. The acquisition of this property for cash or on credit is disadvantageous for them, sometimes even unreal because an entrepreneur not disposing of the required money and, for example, he does not have requested property to guarantee for a loan to the bank. **Expenses related to financial leasing** are, in compliance with Section 24 (2) (h) (2) of Income Tax Act, tax expenses for the payers who keep tax records only proportionally in respect of the agreed period for the relevant taxation period. Basically, it is **accruals and deferrals** of these expenses even if the accruals and deferrals again concern only the units of account but, in this specific case, Income Tax Act imposes them to payers keeping tax records in this specific case.

The outline of quantities and changes in the quantities of stock in the company is kept in the **tax records of stock**. The records should contain information on the real amount of stock, estimation of its value and consumption. The entrepreneur has not to forget that, in compliance with the Act on the administration of taxes and fees, he **has to be able to prove** truthfulness of all facts, in particular in relation with the application of the expenses related to the acquisition of stock in **tax expenses**.

6 Other Tax Records

In relation to the object of business activity, the entrepreneur can keep other records that serve as the source of information for the compilation of pecuniary and non-pecuniary tax income and expenses. It can be, e. g. **records of drives with means of transport, tokens of value, formation and dissolution of reserves, low-value assets, non-pecuniary income and expenses**.

As regards **tax reserves** formed by the payer in compliance with Act 593/1992 Coll., as amended, it can be only a reserve to repair tangible assets in case of a payer keeping tax records in compliance with Section 7 of Income Tax Act. This payer either has not possibility to form adjustments to outstanding receivables because only payers keeping books have this possibility.

If an entrepreneur has his own employees taking wages (employment earnings), he has to keep **wage records**. At the same time, he is responsible for the calculation of levies, including their timely and regular payment in public budget.

7 Determination of the Amount of Assets and Payables at the End of a Taxation Period

In compliance with Section 7b of Income Tax Act, the entrepreneur is obligated to determine the real amount of stock, tangible assets, receivables and payables at the end of a taxation period and to keep written records about it. In order to determine the real amount of stock, it is, therefore, necessary to take an inventory of the specified items of assets and payables despite of the fact that the obligation of stocktaking is related only on the units of account, which is not the case of an entrepreneur who keeps tax records.

In order to be able to regard the result of the stocktaking as provable, one should compile a **record of the real amount of assets and payables at the end of a taxation period**, which has to contain the **names** of the items of assets and the **estimation of their value** according to entries in tax records. In case there is a difference, one has to adjust the tax base in

compliance with Section 24 and 25 of Income Tax Act, i. e. to adjust tax and non-tax expenses.

The payers keeping tax records are not obliged to determine and to verify the real amount of cash and money on bank accounts.

8 Determination of the Personal Tax Base

The taxation period is defined, for the purposes of personal income tax, as the *period of a calendar year* (Section 5 (1) ITA). The income tax base of the entrepreneurs keeping tax records is the amount by which the income of the payer in the taxation period exceeds provable expenses to achieve, ensure and maintain income, unless Income Tax Act stipulates otherwise in case of individual types of income.

After the termination of a taxation period, individuals determine totals of income and expenses in tax records and determine the *tax base* from the difference of the income and expenses in compliance with Section 23 (2) ITA. One has to adjust the difference further on in compliance with ITA (Sections 5 and 23) in order to exclude possible non-tax income and expenses or income and expenses exempted from taxation and to calculate a *tax obligation* in a correct amount.

If expenses exceed income according to tax records on income and expenses, the difference is a *loss*. Income Tax Act stipulates in Section 34 that one can deduct the tax loss, which was calculated and assessed for previous taxation period or its part, from the tax base, however, lasting not longer than five consequent taxation periods for which the tax loss is assessed.

Income Tax Act in its part concerning individuals enables to adjust the tax base particularly in the form of decreasing by the so-called non-taxable amounts (Section 15 ITA) and deductible items (Section 34 ITA).

At the beginning of 2004, a new type of taxation of individuals was introduced in taxation legislation, a so-called *minimum tax base in the amount of a half of an average wage*, however, it was cancelled as of 1 January 2008.

Based on data from tax records, the *entrepreneur prepares a tax return* in the extent determined by the financial authority.

Conclusion

At the end of a taxation period, the tax payer should check whether all income received and expenses paid by the 31 December of the relevant calendar year are recorded. Further, he should check that income is correctly divided in taxable income and income this not being subject to taxation or exempted from taxation and that expenses are correctly divided in taxable and non-taxable expenses. The difference between taxable income and taxable expenses forms the starting amount for further adjustment of the tax base.

Abstract:

The introduction of tax records did not bring the abandonment of the existing basic construction of the system of income taxation. Only the manner of recording is changed by its factual simplification, which has no influence on national taxation policy and on the obligations of persons undertaking an independent gainful activity to record income and expenses in a provable manner and other obligations following from it for tax payers.

The main subject of discussion after the introduction of tax records was the amount of turnover defined by the Value-Added Tax Act for the obligatory **origin of the unit of account and bookkeeping**. The original amendment to the Bookkeeping Act stipulated the limit of CZK 6 mil., the next amendments increased the amount of the turnover to CZK 15 mil. and CZK 25 mil. as of 1 January 2008. Undoubtedly, this regulation will increase requirements for monitoring activities of national institutions because the vague form and

contents of tax records can bring certain problems in practice. It will be practice that shows how justified the increase in turnover to assess the obligation to keep books was.

Summary:

The target of the author is to draw attention to the fact that tax records of an entrepreneur, which has been introduced in the Czech Republic since 2004 and replaced single-entry bookkeeping, has no form regulated in legislation. With regard to its contents, it has to be kept so that it fulfils the targets as they are defined by the applicable provision of the Income Tax Act. However, the article cannot at all clarify the entire issue of tax records and thereto related issue of tax return completely because the legislation of the Czech Republic is varied, contains exceptions and limitations and, therefore, the comprehensive conception of the given issue is very complex.

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