

Tax-Free Allowance in Light of the Theory of Law and Case Law of the Constitutional Tribunal

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Abstract

The article is related to an attempt to evaluate changes in the Personal Income Tax Act in the scope of regulations regarding tax-free allowance, which are a consequence of the judgment of the Constitutional Tribunal of October 28, 2015. The Tribunal recognised that Art. 27/1 of this Act, to the extent that it does not provide for a mechanism to adjust the amount reducing tax, guaranteeing at least subsistence minimum, is inconsistent with Art. 2 and Art. 84 of the Constitution of the Republic of Poland.

Keywords

personal income tax; tax-free allowance; Constitutional Tribunal; case law

1 Introduction

Granted to the legislative authority on the basis of Art. 84 and 217 of the Constitution of the Republic of Poland (The Constitution of the Republic of Poland), the exclusivity of tax bills means freedom in shaping tax obligations, their substantive content, but does not mean that the content of tax legislation is left to the free recognition of the parliament. In the first place, tax legislation is subject to similar rules that apply to other acts. The difference, however, is that the establishment of tax law is based on certain

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principles that are only relevant to this law and have become constitutional standards. These include the abovementioned principle of parliamentary exclusivity in imposing public levies (Art. 84 of the Constitution), the exclusivity principle in determining the essential elements of the legal construction of a tax (Art. 217 of the Constitution) and the rule specifying the requirements to be met by a draft tax act (Art. 123/1 of the Constitution). In drawing up tax acts, the Parliament should also observe all constitutional norms expressing constitutionally protected principles and values (The Constitution of the Republic of Poland). This means that the legislator is bound by a set of directives regarding the creation of tax law. Their violation allows eligible entities to apply to the Constitutional Tribunal (CT) to examine the compliance of the tax act with the Constitution.

The subject of the article is an attempt to evaluate changes in the Personal Income Tax Act of July 26, 1991 (PIT Act) and the manner in which it sets the tax-free allowance. These changes are a consequence of the judgment of the CT of October 28, 2015 (Trybunał Konstytucyjny: K 21/14), which recognised that Art. 27/1 of the PIT Act, to the extent that it does not provide for a mechanism to adjust the amount reducing tax, guaranteeing at least a subsistence minimum, is inconsistent with Art. 2 and Art. 84 of the Constitution.

The main purpose of the article is to try to verify the hypothesis that the current regulation regarding the amount free from personal income tax does not fully implement the provisions of the CT judgment, which is contrary to the Constitution.

In order to verify such a hypothesis, the article presents an analysis of the constitutional principles of tax law creation, in the context of the tax justice principle and related principles of universality and tax equality. It follows from these principles that a properly constructed tax on personal income should take into account the personal ability of the taxpayer to pay taxes and leave at his disposal a part of the income necessary to satisfy his needs (the so-called subsistence minimum).

The research used the dogmatic-legal research method and the analysis of the CT case law.

2 Constitutional Principles of Creating Tax Law

The essential principles regarding the creation of tax law include the principles of Art. 1 and Art. 2 of the Constitution. In the context of tax, the provisions of Art. 1 of the Constitution indicate that by introducing the obligation to pay taxes, “all these values that constitute the Polish statehood, which develop and sustain it, which the Constitution associates with the principle of the common good and which have been expressed in its individual editorial units should be taken into account” (Kulicki, 2016). Art. 2 of the Constitution expresses the principles of a democratic state of law and social justice. An element of social justice is tax justice, which should be understood

as the justice of fiscal burdens of citizens shaped according to the principle of equality (Art. 32 of the Constitution) and universality (Art. 84 of the Constitution) of taxation.

The universality of taxation is expressed in the fact that tax as a non-equivalent benefit should burden everyone so that common needs can be met. It means that the tax obligation rests with all obliged entities, and the tax covers all the factual and legal conditions with which the tax obligation relates. As emphasised by the CT, “paying taxes is one of the duties of individuals towards the state, resulting from the fact that everyone – using various forms of public tasks performed by the state (ensuring safety, maintaining roads) – should also participate in their financing. In other words, everyone is obliged to contribute to the common good according to their own abilities” (Trybunał Konstytucyjny: P 29/13).

However, the universality of taxation does not exclude the possibility for the legislator to grant exemptions or tax-free allowances, “however, any deviation from the principle of the universality of taxation should always be considered in terms of Art. 2 of the Constitution, that is, taking into account the standards of a democratic state ruled by law that implements the principles of social justice” (Trybunał Konstytucyjny: K 41/02). The principle of tax equality shows that all entities that are in the same economic situation (in terms of assets, types of income sources and their size) should be taxed equally (Trybunał Konstytucyjny: SK 2/10). The principle of equality, however, is not absolute, which means that in certain situations it allows to differentiate the legal situation of similar entities, but it has to be justified (Trybunał Konstytucyjny: K 10/96). Tax equality is expressed in the proper distribution of the tax burden, i.e. in proportion to the taxpayer’s ability to pay (Krzywoń, 2011), in accordance with the individual level of his ability to pay. These possibilities are based both on personal and, above all, economic and financial elements (Mastalski, 2014).

An equality in taxation expresses the justice of taxation and it is based on the principle of the ability to pay tax so that all natural persons who receive income in the area of tax operation (personal universality) pay tax on all income obtained from all sources (material universality) (Mastalski, 2014). The doctrine notes that a correctly constructed income tax should respect the principle of taxation of the so-called pure income (Gomułowicz and Mafecki, 2002). That principle, in terms of the subject matter, assumes that only the income remaining at the disposal of the taxpayer should be taxable, intended for satisfying his needs. In this approach, pure income is income generated after deducting the costs of obtaining it. In the personal sense, taxation of the pure income is connected with leaving the taxpayer a minimum tax-free income (at least the so-called subsistence minimum), necessary to meet the needs of the taxpayer and his family. In the literature on the subject, it is pointed out that the omission of this circumstance in the construction of the tax may lead to the necessity for the state to refund taxes in the form of various social benefits “even for those who would be able to live without those in a different tax structure” (Wójtowicz and Smoleń, 1999). For this reason, it is justified to introduce in the structure of personal income tax regulations

that take into account the deviations from the principle of the universality of taxation (Wójtowicz, 1999).

3 Tax-free Allowance in the PIT Act in the Years 1992–2016

The tax-free allowance is part of the construction of progressive personal income taxation systems in most European Union Member States. Its essence consists in excluding an initial amount of income from taxation. In other words, the tax-free allowance is the maximum limit of the tax base (expressed in monetary amount), for which – taking into account the applicable tax rates and in many cases the applicable tax deductible amounts, the tax liability will be zero and will not charge the taxpayer with the payment obligation. The tax-free allowance is related to the tax capacity and as a result determines the tax efficiency.

The method of determining the tax-free allowance can be based on various methods, and their choice depends on the will of the legislator. The first method consists in taking into account the income ranges untaxed on a tax scale in the personal income tax. In this case, this amount usually takes the form of a zero tax rate in the first tax threshold within the limit of a taxable income limit. The essence of the second method of determining the tax-free allowance is the application of a basic (personal) deduction from income, which reduces the tax base by a part of the income of the taxpayer. Finally, this amount can be determined by applying a basic (personal) deduction which is deducted from the input tax (Korolewska, 2015).

Defining the tax-free allowance in the PIT Act of 26 July 1991 relied on the first of the methods presented above. The PIT Act did not directly specify the value of the tax-free allowance, but it indicated the amount that reduced the tax. As a result, the amount of the tax-free allowance is determined by complex calculations.

The PIT Act also provided for a mechanism for the valorisation of the taxable income and the amount by which the tax is reduced. Initially, these amounts were increased to the extent corresponding to the increase in average of the monthly salary in the national economy over the three quarters of the year proceeding the tax year, compared to the same period of the previous year.

A change in the method of valorisation of these amounts took place in 2002 (The Act of November 21, 2001). It was assumed that they should be increased in each year to the extent corresponding to the increase in the prices of consumer goods and services during the three quarters of the year proceeding the tax year in relation to the same period of the previous year. These indicators were announced by the President of the Central Statistical Office. On this basis, the MF, by 30 November of the year proceeding the tax year, determined, by a regulation, the scale of income tax for the following tax year and the tax reduction amount (Art. 27/4–7 of the PIT Act).

At the beginning of 2004 (The Act of November 12, 2003), the mechanism for the valorisation of taxable income bands and the tax-free allowance was abolished

altogether. A fixed, statutory amount, by which the tax was reduced, was set in the amount of PLN 530.08. This amount was increased only once in 2007 (The Act of November 16, 2006), up to PLN 556.02. From that time until 2016, the tax-free allowance remained at a stable, unchanged level of PLN 3,091.

4 Request of the Ombudsman

On October 3, 2014, the Ombudsman filed a motion to the CT to declare the non-compliance of Art. 27/1 of the PIT Act (*Journal of Laws*, 2012, item 361, as amended) in terms of setting in the first range of the tax scale the amount reducing the tax in the amount of PLN 556.02 with Art. 2 and Art. 84 of the Constitution of the Republic of Poland. The Ombudsman related the allegation of unconstitutionality of the challenged regulation with the infringement of the legislator's freedoms in tax lawmaking.

In the justification of the Ombudsman's conclusion, it was stated that setting the amount reducing the tax at the level of PLN 556.02 is detrimental to taxpayers, because this amount was determined in isolation from the poverty criteria adopted in the applicable law. They are determined by the provisions on social assistance, according to which a person living in poverty is a person whose annual income does not exceed PLN 6,504 (in case of a single person), and PLN 5,472 (in case of a person in a family) (The Act of March 12, 2004). As noted by the Ombudsman, the applicable income thresholds entitling to apply for social assistance benefits determine the category of subsistence minimum, i.e. the lowest standard of living below which there is a biological threat to life and psychophysical development of a human being. Tax regulations, however, consider that the annual income above PLN 3,091 is sufficient to impose a personal income tax obligation. Referring to the principle of fairness and the principle of the universality of taxation resulting from it, the Ombudsman stated that the assumption taken by the legislator, that the tax-free allowance (PLN 3,091 during the tax year) by a taxpayer proves that they are able to meet their elementary needs in life to the limits of income set in such a way and at the same time have the real ability to bear public burdens in the form of tax payment. These burdens can be borne only by those who are able to meet these obligations, and therefore must have an income from which it could transfer funds to the resources of the Treasury. In this sense, Art. 84 of the Constitution also raises the obligation to establish such taxes, which take into account the individual payment capability of the person.

The Ombudsman also stated that the total consumer price index in March 2014 compared to March 2008 amounted to 117.9 (price increase of 17.9%) (www.rpo.gov.pl), hence he expressed doubts regarding the abandonment of the mechanism for valorisation of the tax free amount since 2003.

5 Judgment of the Constitutional Tribunal of October 28, 2015

The CT in its judgment of October 28, 2015 ruled that Art. 27/1 of the PIT Act is inconsistent with the Constitution in terms of not providing for a mechanism to adjust the amount reducing tax, guaranteeing at least a subsistence minimum. However, the judgment of the CT did not question the institution of tax-free allowance itself. On the contrary, the CT stated that the amount reducing the tax is an acceptable shaping instrument under Art. 84 of the Constitution's obligation to pay public levies. However, the mere recognition of the legality of the institution does not prejudice the fact that it is shaped in accordance with constitutional requirements. The form of the tax reduction amount must result from the principle of tax justice and implement social justice.

In the justification of the judgment, the CT stated that the absence of a mechanism correcting the amount reducing personal income tax and maintaining the tax-free allowance for many years and making it independent from the socio-economic situation of the state is a defect of the tax law inadmissible in a democratic state of law. It causes the taxpayer's ability to pay tax to be disregarded. The lack of linking tax ability with provisions relating to subsistence minimum or other specific socio-economic indicators is contrary to the principle of social justice and the principle of trust in the state and the laws it legislates. It is not justified, in the light of constitutional principles and values, to have a solution according to which, the tax-free allowance is twice lower than the amount defining living in poverty.

The CT stated that the lack of correction of the tax reduction amount, when it remains unchanged from a number of years, with the loss of the value of money, means its reduction and consequent reduction of its importance in the tax system, which makes it an apparent institution that does not comply with its target set by the legislator. It is unreasonable and unjust to separate the amount that reduces the tax from objective economic and social criteria. It is unreasonable to regulate the tax law, which presupposes a fixed tax reduction amount, thus also a fixed tax-free allowance of PLN 3,091, while social welfare regulations define that a person living in poverty is one whose annual income does not exceed PLN 7,608 in case of a single person and PLN 6,168 in case of a person in a family (The Regulation of the Council of Ministers of July 14, 2015). The amount reducing the tax not synchronised with the ability to pay means that even the poorest participate in the tribute to the state budget from which social transfers are later financed, such as social assistance for the poor. For this reason, tax regulations should take into account individual possibilities of bearing public burdens by taxpayers, so that the general obligation to pay taxes does not contribute to their poverty. This means that the tax-free income amount determined by law should be set at a level of income that will enable a taxpayer a dignified life. The opposite regulations are unconstitutional.

6 Implementation of the Constitutional Tribunal Judgment

Art. 21/1 of the PIT Act, considered by the CT as partly unconstitutional, was to expire on 30 November 2016. On November 15, 2016, the Sejm of the Republic of Poland adopted a bill amending the PIT Act, which provided for the maintenance of the tax scale of 2015 in 2016 and 2017. It aroused concern for the Ombudsman, who, referring to the verdicts of the Supreme Court and administrative courts, pointed out that introducing a legal provision previously recognised as unconstitutional could create the result that “courts while recognizing a specific case or passing a resolution may refuse to apply a legal norm that, despite being declared unconstitutional and eliminating it from the legal order, has been reintroduced into the legal system by the legislator. [...] Therefore, disregarding the Constitutional Tribunal’s judgment and reintroducing the tax-free allowance into the legal system in its existing shape, without taking into account the CT’s guidelines in this regard, may lead to a situation in which the courts, will recognize an amount equivalent to the subsistence minimum as a tax-free allowance” (www.rpo.gov.pl, 2018).

Since passing the amending Act by the Sejm of the Republic of Poland did not end parliamentary work, the Senate of the Republic of Poland amended the bill. Finally, Art. 27 of the PIT Act (The Act of November 29, 2016) defined that the tax is deducted from the basis of its calculation, according to the principle that if it is less than or equal to PLN 85,528, the tax equals 18% minus the amount reducing the tax. If it exceeds PLN 85,528, the tax equals PLN 15,395.04 plus 32% of the surplus over PLN 85,528 minus the amount reducing the tax. The fundamental changes concerned the rules for determining the amount reducing the tax, which was related to the subsistence minimum for a single-person household set by the Institute of Labour and Social Affairs (ILSA). The legislator assumed that the amount reducing the tax should be a support for people with low incomes, while people with high incomes should not use it at all. As a result, the amount reducing the tax is degressive. Its value decreases as the taxpayer’s income in the relevant tax year increases. Added to Art. 27/1b stated that it is:

1. PLN 1,188 – for the tax base not exceeding the amount of PLN 6,600 (people with an annual income of PLN 6,600 or less are exempt from personal income tax);
2. PLN 1,188 reduced by the amount calculated according to the formula: $\text{PLN } 631.98 \times (\text{the basis for calculating tax} - \text{PLN } 6,600) - \text{PLN } 4,400$ – for the tax base higher than PLN 6,600 and not exceeding PLN 11,000 (taxpayer who will receive annual income higher than PLN 6,600, but not exceeding PLN 11,000, will pay a lower tax than previously);
3. PLN 556.02 – for the basis for calculating a tax higher than PLN 11,000 and not exceeding PLN 85,528 (people earning over PLN 11,000 a year, but no more than PLN 85,528 will be taxed, as on the existing rules, the tax-free allowance will amount to PLN 3,091);

4. PLN 556.02 – lessen by the amount calculated according to the formula: $\text{PLN } 556.02 \times (\text{the basis for calculating tax} - \text{PLN } 85,528) \div \text{PLN } 41,472$, for the tax base higher than PLN 85,528 and not exceeding PLN 127,000 (persons obtaining an income over PLN 85,528 annually will pay a higher tax than hitherto, because the tax-free allowance will be gradually reduced in their case; people earning more than PLN 127,000 a year will not benefit from the tax-free allowance).

The new provisions entered into force on January 1, 2017 and were applied to incomes received from that date. The existing rules were applied to the earnings obtained in 2016. The Amending Act also introduced a mechanism for adjusting the tax reduction amount. This amount is verified annually by the Ministry of Finance, which by 15 September of the year in which the verification was carried out, submits to the Council of Ministers information on the results of the verification and the proposal to change the amount reducing the tax for the following year, in case of a significant increase in the minimum subsistence for a single-person household, set by the ILSA. This indicates the unambiguous linking of the amount reducing the tax to the provisions of the Social Assistance Act (SA Act). Art. 9/1 of this Act states that the income criteria defining the threshold for the state social intervention are subject to verification (every 3 years), and the study of the threshold of this intervention is carried out by the ILSA.

On that basis, since 2018 (tax settlement in 2019) the tax reduction amount has been updated, but it is still available only to taxpayers whose annual income did not exceed PLN 85,528. Currently, the tax reduction amount is:

1. PLN 1,440 – for the tax base not exceeding PLN 8,000;
2. PLN 1,440 – reduced by the amount calculated according to the formula: $\text{PLN } 883.98 (\text{tax basis} - \text{PLN } 8,000)$, up to PLN 5,000, for the tax base higher than PLN 8,000 and not exceeding PLN 13,000;
3. PLN 556.02 – for the basis for calculating a tax higher than PLN 13,000 and not exceeding PLN 85,528 (The Act of October 27, 2017).

7 Conclusion

The research that has been carried out and the resulting conclusions did not confirm the research hypothesis set in the introduction.

The personal income tax-free allowance has been an integral element of the Polish tax system since 1992. However, the way it is shaped depends on the will of the legislator. The Polish legislator does not provide for one value of the tax reduction amount and, as a consequence, one tax-free allowance. This amount is regressive in its nature, and may take different values, depending on the amount of the taxpayer's annual income, including the value of '0'. This solution does not raise any doubt. The legislator has considerable freedom in shaping the tax law and can introduce provisions corresponding

to the assumed political and economic objectives, expressing the values protected by the Constitution. This goal is, as emphasised by the judgement of the CT of October 28, 2015, providing the poorest people with a subsistence minimum that guarantees a decent life. It should therefore be considered that the new form of the tax-free allowance in the PIT Act does not violate the said judgement of the CT, thus is not contrary to the Constitution of the RP.

However, one can have doubts whether the act amending the PIT Act of November 29, 2016 setting the tax-free allowance for persons with the lowest income at the level of PLN 6,600 guaranteed at least the minimum subsistence level referred to in the judgment of the CT. The provisions on social assistance, which have been in force since 2015 till now, provide that a person living in poverty is the one whose annual income does not exceed PLN 7,608 in case of a single person and PLN 6,168 in case of a person in a family. This means that the legislator, when determining this amount, referred to the minimum subsistence for a person who remains in the family, and not as it was presented by the CT – for a single-person household. On the other hand, the legislator, specifying the mechanism for valorisation of the tax reduction amount, unequivocally refers it to the subsistence minimum for a single-person household, determined by the ILSA.

It seems that setting the tax-free allowance at the level guaranteeing, in accordance with the SA Act, the subsistence minimum, took place only on the basis of the Act of October 27, 2017, which set the tax-free allowance for people with the lowest annual income of PLN 8,000.

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