Exemption of Polish Local Government Units and their Unions from Corporate Income Tax – The Fundamentals, Evolution of Solutions and Legal Framework

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Abstract

Local government units and their unions as income earning legal entities are subject to the provisions of the Act on corporate income tax. Being subject to income tax law translates also to the opportunity of benefiting from tax privileges established by the law. The establishment and application of tax preferences on income of local government units and their unions is an important instrument in supporting their efforts to perform important – in social and economic terms – public tasks. Tax privileges also serve an important protective function with regard to the public funds being managed by local government units and their unions. To ascertain the fundamentals and the scope of the regulatory law regarding subjective and objective tax exemptions addressed to local government units and their unions, as well as the way in which these regulations evolve, the tax legislation and judicial practice were analysed and the reference literature was reviewed with the application of the dogmatic-legal and empirical methods. The hypothesis on the conditional nature of tax exemption and the need for strict interpretation thereof was proven to be correct. The inability to apply such exemptions in metropolitan unions, which can be interpreted as discriminatory, was evaluated critically. Moreover, it has been proven that the provision of statutory income tax exemption thresholds to local government units and their unions is an overly complicated process since the Act income tax incorporates references to the provisions of the Act on the income of local government units which do not conclusively determine the revenue sources of these entities.

Keywords

local government; source of income; income tax; tax exemptions

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1 Introduction

Local government units (LGU) and unions of LGUs may conduct business activity. Communes are also authorised to conduct business activity extending the tasks of public utility nature [Cf. Art. 9(2) of the Act of 08.03.1990], however only in the cases specified in a separate act. The introduction, by the legislator, of the restriction within the scope of conducting business activity by communes through specification, in particular, of the legal framework in which it may occur is determined by the fact that the aim and sense of existence of a local government are specific public considerations. Conducting of a business activity cannot overshadow the public objectives or excessively involve the activity of communes, whereas not without significance is the fact that specific public tasks imposed on communes are related to organisation and creation of conditions for business activity conducted by other entities (the judgement of the Voivodeship Administrative Court in Olsztyn of 08.09.2011, I SA/OI458/11). A poviat cannot conduct any business activity exceeding the tasks of a public utility nature [Cf. Art. 6(2) of the Act of 05.06.1998].

The tasks performed by an LGU are to satisfy the needs of the local government community and, thus, the nature of the task is public. Performance of such tasks is regulated by provisions of public law and private law, but in any case, this means the necessity for the LGU to be guided by the common good rather than any individual interest. The funds allocated by LGUs and the unions of LGUs to financing of public tasks are public funds, regardless of whether they come from public law sources (e.g. taxes, fees, grants and subsidies) or private law sources (e.g. incomes from tenancy and lease agreements and other agreements of a similar nature, dividends on account of property rights held). The public finance sector units include LGUs and unions of LGUs. Being in possession of these funds, they include them in their budgets, i.e. public financial plans. This is required by the provisions of the Public Finance Act of 27.08.2009 (*Journal of Laws,* 2017 item 2077; Ofiarska, 2017: 158).

The amounts of public funds devoted to performance of public tasks are limited in relation to the needs. The hypothesis has been verified that exemption of the incomes of LGUs and their unions from taxation is the action of a rational legislator aiming at protection of the incomes due to their specific intended purpose. Simultaneously, it has been emphasised that the statutory conditions shaping exemptions from taxation should be interpreted in a strict manner. Pursuant to the standards adopted in Art. 167 of the Constitution of the Republic of Poland of 02.04.1997 (*Journal of Laws,* No. 78, item 483, as amended), the state is obliged to shape the system of LGU incomes in such a manner that is suitable (proper) for the tasks assigned to them. The establishment of tax exemptions targeted at LGUs and their unions should not be understood narrowly as a tax advantage, but more widely, as an element of a systemic solution, the aim of which is to maintain proper relations between incomes of these entities and the scope of their tasks performed in the public interest.

Using the dogmatic legal and empirical methods, the legislation has been examined within the scope of taxation of the incomes of legal entities as well as court decisions and selected items of literature in order to establish the essence, the scope and the main evolution directions of legal regulations concerning the subjective and objective exemptions targeted at LGUs and their unions. It has been demonstrated that the legislator established two categories of exemptions (subjective and objective), but their scopes and aims of use are different. They do not form a specific coherent whole. Through exemption from taxation, the limits of taxation are set, which are determined not only by fiscal objectives, but also by economic, social and political needs (Ofiarski, 2013: 21).

2 Subjective Exemption from Taxation

The provisions of Art. 6(1)(6) of the Corporate Income Tax Act of 15.02.1992 (*Journal of Laws,* 2017 item 2343, as amended, hereinafter: CITA) were added on 01.01.1993, thus, already after the effective date of the provisions of this Act. In the period from 01.01.1993 to 31.12.1994, communes and unions of communes were exempted from income tax, yet only within the scope of their own incomes. From 01.01.1995 to 31.12.1998, the exemption was limited only to communes within the scope of their own incomes. In connection with the introduction of poviat local governments and voivodeship local governments from 01.01.1999, the exemption from taxation under consideration covered all categories of LGUs (communes, poviats, voivodeships) not only with regard to their own incomes, but also all types of incomes mentioned in the provisions of the Local Government Unit Income Act. In this version, the provisions of Art. 6(1)(6) of the Corporate Income Tax Act have already been in force for 20 years.

Pursuant to Art. 6(1)(6) of CITA, LGUs are exempted from this tax within the scope of incomes specified in the provisions of the Local Government Unit Income Act of 13.11.2013 (*Journal of Laws,* 2017 item 1453, as amended, hereinafter: LGUIA). The limits of this exemption are set by the scope of the term "local government unit" as well as the catalogue of incomes mentioned in LGUIA. The interpretation of the provision of Art. 6(1)(6) of CITA, as the provision introducing exemption from taxation, should be conducted in a strict manner (Brzeziński, 2013: 48). In tax law, the result of interpretation of law cannot change the scope of taxation, the determination of which belongs solely to the sovereign rights and duties of the state establishing tax legislation (Brolik, 2014: 59).

The constitutional standard formulated in Art. 217 of the Constitution of the Republic of Poland permits for establishment of categories of entities exempted from taxes by means of a law. The subjective category in the situation under consideration is the LGU, yet no legal definition of it has been formulated in any legal act. The Constitution of the Republic of Poland uses the terms "territorial unit" [Art. 15(2)], "local government" [Art. 16(2), Art. 62(1), Art. 94, Art. 107(1), Art. 123(1),

Art. 146(2), Art. 148(6)] and "local government unit" (chapter VII of the Constitution of the Republic of Poland entitled *Local Government*). The literature has correctly considered that the above mentioned terms have different semantic scopes (Chmielnicki, 2004: 142).

The ordinary acts mention specific types of entities which belong to the general category of LGU, e.g. in Art. 2(1) of LGUIA or in Art. 1(2) of the Act of 24.07.1998 on the introduction of basic three-tier territorial division of the state (*Journal of Laws,* no. 96, item 603, as amended). Communes, poviats and voivodeships have the legal status of an LGU. The legislator is consequent and, in other legal acts, distinguishes LGUs from other entities included in the local government sector, e.g. Art. 1(2) of the Act of 07.10.1992 on regional accounting chambers (*Journal of Laws,* 2016 item 561) except for LGUs also mentions the following unions: metropolitan unions, inter-communal unions, commune associations, associations of communes and poviats, poviat unions, poviat and commune unions, poviat associations, local government organisational units. The LGU unions and associations are not LGUs and, thus, cannot be covered with the subjective exemption specified under Art. 6(1)(6) of CITA (*Journal of Laws,* 2016 item 561). Neither can the metropolitan union be established based on the Act of 09.03.2017 on the metropolitan union in the Silesian Voivodeship (*Journal of Laws,* 2017 item 730). The metropolitan union is the association of the communes of the Silesian Voivodeship, characterised by the existence of strong functional links and advanced urbanisation processes, located on the spatially coherent area, which is inhabited by at least 2,000,000 citizens. It is not a municipal union within the meaning of systemic local government acts and the regulations on inter-communal unions, unions of poviats or poviats and communes shall not be applied to it, even respectively. Interchangeable treatment of LGUs and LGU unions is not permissible also due to the fact that there are no such provisions in the Tax Act as the ones included in Art. 4(2) of the PFA stipulating that the provisions of the act concerning LGUs are respectively applied to metropolitan unions as well as unions of communes and poviats.

Neither are LGUs the auxiliary commune units (villages, districts, housing estates and other), which shall only be treated as components of communes. Outside communes, they have no independent legal existence and, thus, cannot be treated as taxpayers exempted from taxation. For the same reasons, other units that cannot be equated with LGUs are the organisational units created pursuant to a certain scheme enabling their operation, having assets and human resources at their disposal, participating in business transactions and, in spite of no legal personality, being a fiscal and legal subject in the corporate income tax. Local government budgetary establishments are organisational units of LGUs, but, at the same time, are entities separated from LGUs and do not enjoy the exemption from corporate income tax (the judgement of the Voivodeship Administrative Court in Gdańsk of 08.02.2007, I SA/Gd 590/06).

Pursuant to Art. 6(1)(6) of the CITA, incomes of LGUs are exempted from taxation and, thus, the exemption cannot include the incomes obtained by LGUs e.g. from privatisation of the LGU assets or sale of securities. The provisions of the PFA,

in the category of "public funds", distinguish "public incomes" and "public revenues". Nevertheless, in the provisions of the CITA, the terms "income" and "revenue" are treated by the legislator in such a manner as if they were of a synonymous nature. In particular, Art. 22(1) of the CITA may be indicated, pursuant to which income tax on income from capital gain (e.g. for the share in profits of legal entities, for withdrawal of a partner from a company, for transformations, mergers or divisions of entities), from dividends and other revenues (incomes) for participation in profits of legal entities whose registered office or management board are located in the territory of the Republic of Poland are determined at the rate of 19% of the obtained revenue (income). Pursuant to Art. 6(1)(6) of the CITA, if such incomes (revenues) are obtained by LGUs, they should be exempted from taxation (e.g. the individual interpretation of 07.02.2018 issued by the Director of the National Tax Information, 0111-KDIB1-1.4010.145.2017.2.MG).

The above formulated conclusion shall not, nevertheless, be adopted without any reservations. Evoking the "incomes" of an LGU in Art. 6(1)(6) of the CITA, the legislator makes a reference, within this scope, to the provisions of the LGUIA. This means that the scope of this term is determined otherwise than in the provisions of the LGUIA. Art. 3(1–2) of the LGUIA mentions the types of LGU incomes, which include (the so called regular incomes): own incomes, general subsidies, targeted grants from the state budget, shares in personal income tax and corporate income tax receipts. Pursuant to Art. 3(3) of the LGUIA, LGU incomes may also include (the so called additional incomes): non-returnable funds from foreign sources, funds from the EU budget, other funds specified in separate regulations. In this case, the catalogue is of an open nature (Ruśkowski and Salachna, 2004: 94), because other incomes are specified by a separate act to which the legislator refers in Art. 6(1)(6) of the CITA. A question arises whether the exemption from taxation also applies to other LGU incomes which are not mentioned by the LGUIA and, thus, whether the reference to Art. 6(1)(6) of the CITA should be understood narrowly and include only the provisions of the LGUIA or broadly refer also to other acts regulating the types of LGU incomes. A characteristic feature of many regulations included in the LGUIA is their framework (general) nature (e.g. the act mentions only several types of targeted grants, the principles and procedure of granting which are regulated by separate acts). Art. 4–6 of the LGUIA include catalogues of own income sources of the respective communes, poviats and voivodeships. None of these catalogues includes a full list of all types of incomes and, thus, these are open catalogues. Such nature of the catalogues is proven by the expressions used by the legislator, like e.g. "receipts from other fees constituting the incomes of a commune (poviat) paid based on separate regulations", "incomes from financial penalties and fines determined in separate regulations", "other incomes due to a commune (poviat, voivodeship) based on separate regulations".

In conclusion, based on the provisions of Art. 6(1)(6) of the CITA and the provisions of the LGUIA, it is not possible to determine explicitly the limits of exempting LGU incomes from taxation. Systematic analysis of many separate acts is necessary within this scope, whereas, in the provisions of the LGUIA, the legislator does not refer to

any specific acts, but only uses a very general statement "separate regulations", which, in practice, may not only mean legal acts of a statutory rank, but also the secondary legislation in the form of regulations of the Council of Ministers and individual ministers.

3 Objective Exemption from Taxation

Pursuant to Art. 17(1)(4) of the CITA, the unions of LGUs have been exempted from taxation, however only in the part intended for these units. In this version, the provisions of the Tax Act have been in force since 01.01.1999 and an amendment to it was connected with the reform of the local government in Poland involving the establishment of poviats and voivodeships as new categories of LGUs. In the period from 01.10.1995 to 31.12.1998, all incomes of commune unions in the part intended for communes were subject to exemption.

The legislator has consequently assumed, since the moment of introducing this exemption, that the object of exemption may be exclusively the incomes of an LGU union in the part intended for LGUs being members of the union. A different point of view has also been expressed in the doctrine, according to which exemption from taxation also covers the incomes of an LGU union for any LGU and, thus, it does not even have to be a member of the specific LGU union (Mariański et al., 2011: 417). Nevertheless, it is difficult to accept this point of view as the content of Art. 17(1)(4g) of the CITA includes the phrase "for these LGUs", i.e. being members of the specific LGU union which allocates its incomes to them. The incomes of an LGU union transferred to another entity, e.g. a joint stock company created by an LGU, are not subject to exemption because such an entity cannot be a member of the LGU union (Judgement of the Voivodeship Administrative Court in Gliwice of 12.01.2012, I SA/GL 1081/11).

Pursuant to Art. 17(1a)(2) of the CITA, the exemption from taxation under consideration does not apply to incomes, regardless of the time of obtaining them, spent on any other purposes than the needs of LGUs being members of the LGU union. Furthermore, pursuant to Art. 17(1b) of the CITA, the exemption from taxation shall apply if the income is allocated to – and regardless of the date – spent on the needs of LGUs being members of the LGU union, including on the purchase of tangible and intangible assets used directly to meet these needs, as well as on payment of taxes not constituting the cost of obtaining revenues. Using by the legislator of the qualifying expression "including also for the purchase of tangible and intangible assets used directly to meet these needs" in the above quoted provision suggests an example enumeration of the circumstances (grounds) being the basis for exemption (the judgement of the Supreme Administrative Court of 18.08.2004, FSK 207/04). This means that the provision also covers various, uncategorised (except for the case explicitly separated by the legislator) expenses if only they are ultimately targeted at the achievement of

specific objectives specified therein (the judgement of the Supreme Administrative Court of 17.12.2008, II FSK 1399/07).

The manner of interpretation of the provisions of Art. 17(1)(4g) of the CITA by tax authorities has evolved specifically. Initially, tax authorities interpreted the statutory expression "in the part intended for LGUs" very narrowly, considering that only the part of incomes of LGU unions allocated directly to the needs of LGUs being its members may be subject to exemption. The right to exemption from taxation of these incomes of an LGU union, which the LGU union allocated to its own needs was refused (e.g. the letter of the Tax Chamber in Bydgoszcz of 14.01.2008, ITPB3/423-127/07/AM). In subsequent years, tax authorities began to treat the statutory expression "in the part intended for LGUs" more flexibly. The change in the manner of understanding the statutory expression was influenced by the decisions of administrative courts (e.g. the judgement of the Voivodeship Administrative Court in Krakow of 16.11.2007, I SA/Kr 805/07). A tendency developed, according to which both expenses financing the general costs of an LGU union which performs the public tasks of LGUs creating the union as a whole, as well as expenses of the LGU union connected with its activity involving directly the performance of public tasks within the scope of the activity of the LGU creating the union should be exempted from corporate income tax. It was considered that the expenses incurred for financing of the general costs of the LGU union established by LGUs, as well as the expenses connected with its activity are the expenses intended for these LGUs. It was emphasised, at the same time, that it is not right to equate the expression "allocation" with "transfer" of the incomes of LGU unions because, in practice, this leads to limitation of the tax exemption only in the part of the incomes which were directly transferred for the benefit of the LGU creating the union. Such an interpretation would cause exclusion from the possibility of tax exemption of the funds indirectly allocated to the needs of the LGU creating the union (e.g. the individual interpretation of 17.04.2018 issued by the Director of the National Tax Information, 0111-KDIB1-2.4010.95.2018.1.PH.). Official interpretations appeared which excessively extended the limits of the exemption from taxation under consideration, e.g. regarding exemption of the income of an LGU union from a financial prize received in a competition organised by the Voivodeship Fund for Environmental Protection and Water Management subsequently allocated as a whole to the needs of the LGU being members of the union related to the purchase of coffee machines and a sound system (e.g. the letter of the Tax Chamber in Bydgoszcz of 21.01.2015, ITPB3/423-572/14/KK). Another example was permitting of an exemption from taxation of the income of an LGU union allocated to the purchase of the service related to the organisation of the opening ceremony of a bus station building (e.g. the letter of the Tax Chamber in Katowice of 16.12.2003, IBPBI/2/423-1194/13/PP) or the income of an LGU union allocated to financing of the general costs of the LGU union's activity (maintenance of the registered seat, offices, administration, payment of subsistence allowances for the LGU union's governing bodies) (e.g. the letter of the Tax Chamber in Katowice of 18.02.2013, IBPBI/2/423- 1441/12/CzP).

A general expression "incomes of an LGU union" is used in the content of Art. 17(1)(4g) of the CITA. These may be incomes from public law and private law sources obtained by the individual LGU union. The sources of incomes of LGU units are determined in their statutes, whereas planned incomes and expenses – in the budget resolutions of these unions. Sometimes the statutes of LGUs contain a factual mistake because, the expression "the incomes of the union include" are followed by the list of incomes and revenues within one catalogue (Ofiarska, 2012: 324), whereas these are separate semantic categories within the meaning of the provisions of the PFA. Most frequently, statutes of LGU unions mention the following sources of incomes: membership fees; receipts from the assets, establishments and devices of the union; shares of the union in companies and other business undertakings; donations, inheritances and bequests; grants and subsidies; incomes from the activity of the union; other incomes and benefits.

The nature of exemption from taxation specified in Art. 17(1)(4g) of the CITA is internally complex. In spite of a commonly accepted view about its objective nature, it is a mixed exemption, i.e. a subjective and objective one. It applies only to a group of addresses determined by the hypothesis of the norm included in this provision and, at the same time, it refers only to a category of incomes strictly specified by the legislator. The exemption cannot be classified as subjective because this would lead to the conclusion that any income generated by an LGU union and invested in its activity would be an income allocated to the LGU creating it. Such an interpretation would be inconsistent with the literal wording of the provision and would lead to the conclusion that the fragment is redundant. The content of the provision explicitly determines the inclusion of only a specific part of incomes of an LGU union within its scope, i.e. the income which is not intended for the LGU creating it and is used for the activity of the LGU union itself cannot be covered with the exemption from taxation (the judgement of the Supreme Administrative Court of 09.11.2016, II FSK 3346/14). Currently, a critical assessment of the interpretation activity of tax authorities within this scope is noticeable in the decisions of administrative courts. The need of interpreting this provision introducing the exemption from taxation in a very precise and strict manner is emphasised, whereas the role of an interpretative authority should not be replacement of the legislator (the judgement of the Supreme Administrative Court of 09.11.2016, II FSK 3214/14).

4 Conclusion

Exemption from taxation of LGU incomes (subjective exemption) has a wider scope than exemption of the incomes of LGU unions (subjective and objective exemption). The first one covers all incomes of LGUs regardless of their source of origin (public law or private law) or the manner of spending. The second exemption is limited only to this part of the incomes of LGU unions which was allocated to LGUs being members

of the union. Tax exemptions constructed in this manner do not protect all incomes included in the budgets of LGUs or LGU unions from taxation. In particular, the scope of these exemptions does not cover incomes or revenues obtained by local government budgetary establishments, being the organisational units separated from LGUs and their unions, settling with the respective budget through payment of the surplus of current assets. Local government budgetary establishments are organisational units established by the decision making bodies of LGUs and LGU unions for performance of specific public tasks satisfying the needs of local and regional communities. Formally, local government budgetary establishments, in spite of their lack of legal personality, are taxpayers of the corporate income tax.

The hypothesis which has been positively verified is that exemption from taxation of the incomes of LGUs and their unions is not only a narrowly understood tax privilege, but it also performs a protective function for the resources of public funds being at the disposal of these entities intended for performance of public tasks. Such an exemption may be treated as an important construction element of the constitutional and statutory mechanism assuring the adequate share of LGUs in public incomes in relation to the scope of public tasks assigned to them for performance.

Assessment of the applicable legal solutions concerning exemptions of LGUs and their unions from taxation as well as problems related to their practical application justify filing of specific motions de lege ferenda. The principle of equal treatment of entities being in a similar situation to LGUs and their unions, demands their equality in the aspect of exemption of their incomes from taxation. LGU unions should benefit from tax exemption within the same scope as the LGU creating them.

Another postulate refers to the introduction of a comparable exemption from taxation of the incomes of a metropolitan union. In the current legal situation, the entity is not covered with the subjective exemption specified in Art. 6(1)(6) of the CITA or the subjective and objective exemption regulated in Art. 17(1)(4g) of the CITA. Incomes of the metropolitan union, similarly to incomes of LGUs, are allocated to performance of public tasks and, thus, should also benefit from a tax exemption.

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