TAXATION OF NATURAL PERSONS' MONEY CAPITAL GAINS: LEGAL AND FINANCIAL ASPECTS

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Abstract

Since 2002 in Poland there have been introduced new regulations of the taxation of natural persons' capital gains. According to them there were abolished most exemptions on incomes from savings deposits, Treasury Bonds and capital funds as well as profits from securities transactions. Because the new rules of natural person's taxation substantially influenced money and capital market in Poland as well as became important source of state budget inflows, this article presents the main legal and financial aspects of the mentioned taxation.

Key words

lump-sum tax, flat rate tax, tax rate, tax exemptions, revenues, incomes

Introduction

Money capitals are some significant sources of revenues and incomes received by natural persons. In Poland major money capital revenues are: interest on loans, interest on savings deposits and other financial means on bank accounts, interest and discount on securities, dividends and other revenues from participation in profits of legal persons, revenues from participation in capital funds, revenues due, even if not received, from selling on shares in companies and selling on securities and revenues from exercising rights attached to securities, revenues from selling on preemptive rights, revenues of employees' retirement pension funds members earned from transfer of the shares deposited on quantity accounts into the assets of those funds, nominal value of shares in companies or contributions in cooperatives taken up in exchange for a non-cash contribution, revenues from selling on derivative financial instruments and from exercising rights attached thereto[1]. Until 2002 several major types of revenues (incomes) from money capitals were tax exempted, especially revenues earned on

[1] *Ustawa z dnia 26 lipca 1991 o podatku dochodowym od osób fizycznych*, Dziennik Ustaw 1991, No 80, Item 350.

bank deposits, capital funds, State Treasury securities and stock exchange transactions. Because of substantial state budget deficit, the financial authorities of the Republic of Poland decided to enlarge scope of taxed revenues. Since March 2002 the capital gains tax exemption on: interest and discount on State Treasury securities and local government bonds, interest on savings deposits, incomes on capital funds investments and interest and guarantee bonuses on deposits to housing savings books, had been abolished[2]. Furthermore, since 2004 capital gains taxation has embraced incomes earned from selling off State Treasury and local governments bonds, incomes earned from transfer of securities admitted to public trading, as well as incomes earned from the execution of rights attached to the securities[3]. In 2004 taxation of money capital gains was unified and tax rate of 19% replaced the rate of 15% related to taxation of dividends and the rate of 20% related to taxation of interest earned from deposits and capital funds. The new principles of money capital taxation have been called Belka's Tax from the name of its originator and their regulations were added to the Personal Income Tax Act. After amendments to Polish tax law almost all kinds of revenues (incomes) earned by natural persons from money capitals became a subject to personal income taxation. As the taxation of capital gains substantially influenced the fiscal system and financial market of the Republic of Poland, the aim of this article is to describe main aspects of legal regulations, as well as fiscal and economic consequences of natural persons capital gains taxation in Poland.

Legal regulations of money capital gains taxation in Poland

In Poland the capital gains of natural persons are subject to taxation according to two different methods: the lump-sum tax and the flat-rate tax. In both cases, the tax rate is 19% of the revenue (income) earned.

Revenues earned from: interest on loans, interest or discounts on securities, dividends and from participation in profits of legal persons, interest and other revenue from financial resources accumulated in the taxpayer's account run by the entitled entity, as well as money paid out to the heir or other entitled person after the death of the member of open pension fund and the transfer of the preemptive right for newly issued shares by employees'

[2] *Ustawa z dnia 21 listopada 2001 o zmianie ustawy o podatku dochodowym od osób fizycznych oraz ustawy o zryczałtowanym podatku dochodowym od niektórych przychodów osiąganych przez osoby fizyczne*, Dziennik Ustaw 2001, No 134, Item 1509.

[3] *Ustawa z dnia 12 listopada 2003 o zmianie ustawy o podatku dochodowym od osób fizycznych oraz niektórych innych ustaw,* Dziennik Ustaw 2003, No 202, Item 1956.

retirement pension fund on behalf of a member of the fund are subject to lump-sum tax of 19%[4]. The lump-sum taxation is also applicable to income earned on money capitals, instead of revenues. The examples of incomes being subject to lump-sum tax are: profit from participation in capital funds (investment funds, insurance capital funds), income of members of the employees' retirement pension funds earned from transfer of the shares deposited on quantity accounts into the assets of those funds, as well as income earned when withdrawing funds from individual pension account or employee's retirement scheme. In case of taxation of incomes earned from capital funds, the Polish tax law states that, if it is not possible to identify remitted participation units or repurchased investment certificates bought at a discount, the investor's income is assessed upon the FIFO approach.

Generally, the revenues and incomes, which are subject to the lump-sum taxation, are not revealed in Poland in the annual tax statements submitted to the tax office by taxpayers[5]. The money capital incomes taxed in the form of a lump-sum cannot be combined with incomes earned and taxed under general rules.

Regulations related to taxation of income from interest earned abroad by domestic investors are applicable with accordance to the Directive 2003/48/EC and the double taxation avoidance agreements to which the Republic of Poland is a party. The taxpayer who earns outside Poland incomes from interest, dividend and capital funds may deduct the amount of tax paid abroad from the tax assessed on that income according to Polish tax law. The deduction cannot exceed the amount of tax calculated with 19% tax rate.

The incomes earned from transfer of securities or derivative financial instruments, from exercise of rights attached thereto, and from transfer of shares in companies, as well as from shares taken up in companies or contributions taken up in cooperatives in exchange for a non-cash contribution in another form than an enterprise or an organized part thereof, are subject to 19% flat-rate tax[6]. An income shall be assessed as a difference between total revenues earned from transfer against consideration of securities and derivatives or revenues earned from exercise of rights attached to them and revenue earning costs. The examples of such costs are: expenditures on taking up contributions in a cooperative, expenditures on

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[4] *Tax Administration and Tax System in Poland*, "Tax Information Bulletin", Ministry of Finance, 2004.

[5] Amounts of lump-sum income tax calculated for revenues (incomes) earned outside the Republic of Poland, and amounts of tax paid abroad are shown by taxpayers in the tax statement.

[6] *Tax Administration and Tax System in Poland*, op. cit.

acquisition of shares and other securities in a company, expenditures on acquisition of capital fund participation titles or participation units. Also, the revenue earning costs are: expenses connected with acquiring derivative financial instruments while executing of rights attached to such instruments or resigning from the exercise of rights attached to them or transferring them against consideration. An example of income from taking up contributions or shares in exchange for non-cash contribution in another form than an enterprise or an organized part is a difference between nominal value of shares or contributions and initial value of the object of contribution decreased by the depreciation write-offs made before making contribution if the object of the non-cash contribution is fixed assets or intangible assets or legal value. If a taxpayer transfers securities acquired at different prices and it is impossible to determine the acquisition price of the securities being transferred, the rule that shall apply when determining the income from such transfer is that each transfer shall be made in respect of the securities acquired at the earliest date (FIFO method). The mentioned rule shall apply separately for each securities account.

In contrary to the lump-sum taxation, the taxpayer who earns income from transferring against payment of securities, derivative financial instruments and from exercising of rights attached to them, as well as taxpayer who earns income from transferring against payment shares in companies or contributions in a cooperative taken up in exchange for a non-cash contribution in other form than an enterprise or an organized part thereof after the tax year is obliged to present in the tax statement incomes earned and to assess due income tax. If the taxpayer incur a loss from securities transactions in a given tax year, he may deduct such loss from the income earned from that source during the immediately following five subsequent tax years. However, the amount of such deduction in any of these years may not be higher than 50 per cent of the amount of such loss.

If the taxpayer receives incomes from transfer of securities in Poland and in other countries, those incomes shall be combined and the amount of income tax paid in abroad is deducted from the tax calculated for the total income. This deduction cannot exceed the part of tax calculated before the deduction and proportionally corresponding to the income earned in a foreign state. Regulations related to taxation of income from transfer of securities are applicable with accordance to double taxation avoidance agreements to which the Republic of Poland is a party.

The capital gains tax exemptions

The construction of the money capital gains tax does not provide substantial tax exemptions and thus does not allow reducing tax burden. Some existing exemptions are related to the time of setting up the source of revenue (income). For instance, tax exempted are incomes earned from interest and discount on securities issued by the State Treasury, and on bonds issued by territorial self-government units – acquired before 1 December 2001. Also, tax exempted are incomes (revenues) from cash means collected by the taxpayer before 1 December 2001 under the contracts concluded before that date for a definite period of time. Moreover, the tax exemption is applicable to interest and guarantee bonuses from deposits to housing savings books. There is also tax exemption on incomes earned from share in the capital funds if the incomes are paid to the taxpayer under the contracts concluded or records made by the taxpayer before 1 December 2001. However, the exemption does not embrace incomes earned in connection with the accession to the capital fund's savings program, irrespective of its form – for the incomes earned on the payments (contributions) made to such fund which have been made since 1 December 2001. In case of contracts concluded from 1 December 2001 to 28 February 2002 the exemption applies only to the income earned within this period[7]. Apart from lump-sum tax exemptions, there are some exemptions in flat-rate tax imposed on income from transfer against payment of securities. Tax exempted are incomes earned on trade of securities admitted to public trading, acquired on the basis of the public offer or on the Stock Exchange or in regulated over-the-counter secondary public trading, purchased before January the 1st 2004[8]. Tax exempted are also incomes from exercising rights from securities acquired before that date. Also, tax exemption embraces incomes from transfer against payment of treasury bonds issued after 1st of January 1989 and acquired before 1st of January 2003 as well as local government bonds issued after 1st of January 1997. However the exemption is not applied if the transfer of securities is in connection with the business activity conducted. In case of transferring of securities acquired before the 1st of January 2004 the individual is not obliged to submit to revenue offices a statement on the amount of income earned (loss incurred) during the tax year.

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[7] 1 December 2001 to 28 February 2002 is a transitional period.
[8] T. Zalewski, *Kiedy zyski z giełdy nie są opodatkowane*, „Gazeta Prawna” nr 75, 17.04.2007

Fiscal significance of money capital gains tax

The main role of the capital gain tax in the financial system is to raise state budget inflows. The significance of the tax is greater during the period of dynamic growth of the capital market and the whole economy, when individual investors are willing to earn additional money on their accumulated capitals. The increasing value of stock and participation units of capital funds increase the amount of financial profits and thus the value of tax collected. Abolishing in 2002 tax exemptions on revenues from savings deposits and capital funds incomes as well as in 2004 from transfer of securities admitted to public trading was to increase state budget incomes and to reduce the budget deficit. The Belka's Tax applied to interest, discount and incomes from capital funds earned by individuals brought state budget incomes as follows: 2002 – 0,8 bln PLN, 2003 – 1,16 bln PLN, 2004 – 0,98 bln PLN, 2005 – 1,26 bln PLN, 2006 – 1,4 bln PLN. Adequately, the tax incomes from transfer against payment of securities were as follows: 2004 – 0,56 bln PLN, 0,83 – bln PLN, 2006 – 1,1 bln PLN. The total amount of inflows from money capital gains taxation of natural persons reached then 2,5 bln PLN in 2006, what was approx. 5,1% of total inflows from PIT[9]. The estimated level of inflows from this tax in 2007 is 4 bln PLN. This amount should cover about a half of the state budget deficit reduction (from 30 to 24 bln PLN) expected in 2007. As in the last few years the consumer price index (calculated December-December) in Poland had rather low value, i.e. 2002 – 100,8, 2003 – 101,7, 2004 – 104,4, 2005 – 100,7, 2006 – 101,4, the budget incomes from taxation of interest and discounts were not artificially inflated[10]. Because of very advantageous capital market conditions reflected in high returns on stock investments as well as general low level of interest rates in Poland, the natural persons were not strongly affected by this taxation and could easily get accustomed to it. The steadily increasing value of capital funds assets (from 62 to 100 bln PLN in 2006) and the number of investing accounts (from 856,4 thou. in 2006 to 925,5 thou in the mid of 2007) may indicate that investing conditions in Poland are perceived as very advantageous[11]. Thus, one may expect higher inflows from the capital gains taxation in the future. As the budget incomes from this source have been steadily increasing, the liquidation of this tax seems to be little possible.

[9] Data: Ministry of Finance of the Republic of Poland, www.mofnet.gov.pl
[10] Data: National Bank of Poland, www.nbp.pl
[11] *Dochodowy podatek Belki*, Gospodarka.pl, 10.05.2007, www.egospodarka.pl

Economic consequences of capital gains taxation

The introduction of taxation of several kinds of revenues i.e. treasury bonds and savings deposits interest, as well as profits earned from capital funds and stock exchange transactions significantly influenced structure of investments of natural persons in Poland. The time lag between introducing the lump-sum tax (2002) and flat-rate tax (2004) caused transfer of money from savings deposits to stock exchange investments and capital funds anti-tax products. The taxation also motivated Polish investors to change attitudes toward investing money. Low risk investments which were dominating among natural persons in Poland started to be replacing with more risky but more profitable and tax exempted capital market investments. This process led to reducing the growth rate of deposits in the banking sector and boost growth of capital funds market, and thus the whole capital market. A very strong demand for bank loans (especially mortgage loans) combined with a weak demand for low profitable bank savings deposits contributed in the second half of 2007 to excess of the value of credits over the value of deposits[12]. Such tendency might lead in the nearest future to use more foreign market financing and to raise costs of credits for individuals and companies. The change of attitude of natural persons to invest more money at capital market strongly supported development of domestic capital funds and enhanced foreign funds to offer their investment products in Poland. The increase of net assets value under management of capital funds in the period of introducing the new taxation was: 2001-2002 - 91,7% and in 2002-2003 - 43,5% [13]. The inflow of money to capital funds has created additional demand for stock at Warsaw Stock Exchange, and thus strengthened growth of Polish capital market.

As taxation of capital gains reduced to some extent net profits earned by natural persons at the capital market and thus income available to reinvestment, some financial institutions introduced several anti-tax products. In the past there were issued the anti-tax bonds but since 2004 they have been replaced by more complex instruments. At present the dominant role play insurance companies (e.g. Commercial Union, Generali, Allianz, Nordea, Europa) that has been selling structured financial products called „Insurance policy to live to". Such products in majority consist of capital funds wrapped up in insurance policies. Income gained on paid-in capital is treated as compensation not as taxable revenue, hence it is tax

[12] Since 2002 the value of non-current bank savings deposits of natural persons is systematically decreasing.
[13] *Rozwój systemu finansowego w Polsce w latach 2002-2003*, Narodowy Bank Polski, Warszawa 2004, s. 106

exempted[14]. Other tax-exempted products available on the Polish capital market are umbrella funds. The umbrella fund is a construction of capital fund with at least two subfunds of different investing strategies. The transfer of capital between subfunds, unlike transfer between separate funds, is tax exempted. Such construction enables effective investing in variable market conditions and changing of investment strategy is not a subject to taxation[15]. In fact, the tax is collected from investor's income in time of final withdrawing of capital (tax deferral) from the umbrella fund. Apart from umbrella funds, some traditional capital funds are offering investment strategies with reduced tax payment. Such strategies are based on using LIFO and HIFO methods of redemption of participation units. In practice, LIFO or HIFO does not eliminate income tax obligation but it reduces its current payment.

At present, the tax rate is unified at the flat rate of 19% and all the income amount is a subject to taxation. Also, there is no preference in taxation of particular financial investments, as well as the tax rate is constant regardless of the duration of investment. Thus, the 19% rate charge long-term and short-term investments.

Apart from the fiscal reason of maintaining of this tax, the only economic reason justifying the natural persons capital gains taxation seems to be enhancement of individuals' pension accounts system. The individual's pension accounts is a form of voluntary pension saving provided by e.g. bank, insurance company, investing house, capital funds company. It is one of the three official forms of gathering capital for individual's retirement but it is still limited by legal and financial factors. The capital gains tax exemption is at present the unique advantage distinguishing the program among the other forms of saving and investing money.

Conclusions

The capital gains tax imposed on revenues (incomes) of natural persons has become important source of the State budget incomes. Substantial growth rate of the Polish capital market additionally raised its significance over the last two years. However, the construction of the tax itself is rather complex and its assessment as well as settlement problematic. Also the rate of 19% may be considered as excessive in terms of developing whole financial market and

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[14] A. Borys, *Nowy sposób na podatek Belki*, „Puls Biznesu", 23.05.2007
[15] *"Podatek Belki": Jak go uniknąć?*, Gospodarka.pl, 10.05.2007, www.egospodarka.pl

increasing relation of bank assets to GDP or stock market capitalization to GDP[16]. Taxation of any money investment incomes in Poland may lead to reduction of competitiveness of Polish economy and transferring funds into other low-tax countries of Central and Eastern Europe. Despite several announcements of abolition of capital gains tax, which were made within last two years, no specified actions were taken in this scope. As the complete abolition of the tax is hardly possible in the nearest future, some amendments to the tax regulations should be made. The most important areas are capital funds incomes and savings deposit incomes, where individuals cannot deduct losses incurred or costs of accounts servicing.

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[8] *Ustawa z dnia 26 lipca 1991 o podatku dochodowym od osób fizycznych*, Dziennik Ustaw 1991, No 80, Item 350.

[9] Zalewski T., *Kiedy zyski z giełdy nie są opodatkowane*, „Gazeta Prawna" nr75, 17.04.2007

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1. Ministry of Finance of the Republic of Poland, www.mofnet.gov.pl
2. National Bank of Poland, www.nbp.pl

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[16] The tax rate of 19% in Poland is generally lower than in some well developed EU countries, like: Denmark (28%, 43%), Finland (28%), France (26%), Germany (25%), Sweden (30%). See: *Capital gains tax*, Wikipedia, http://en.wikipedia.org