

# New approach to taxation of severance benefits introduced

October 05 2016 | Contributed by [Sołtysiński Kawecki & Szlęzak](#)

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On June 23 2016 the Ministry of Finance issued a general interpretation of the Personal Income Tax Act 1991 provisions regarding the tax exemption applicable to compensation received by employees under voluntary redundancy programmes. The interpretation introduces a new approach to the taxation of such benefits and will most likely impact the tax authorities' practice in this respect.

This issue is directly related to the practical application of Article 21(1)(3) of the Personal Income Tax Act, which states that – among other things – indemnities and compensation will be exempt from income tax if:

- their value or the rules for determining their value stem directly from collective labour agreements, other collective agreements, regulations or statutes referred to in the Labour Code; and
- they are not explicitly excluded from the above exemption (eg, severance paid pursuant to the provisions on special rules of termination of employment due to reasons unrelated to employees).

According to the tax authorities, severance related compensation payable to employees under collective agreements or employers' regulations on voluntary redundancy programmes are exempt from personal income tax (regardless of the effective taxation of statutory severance pay which may be paid simultaneously).

## General interpretation

In its June 23 2016 general interpretation, the Ministry of Finance ruled that benefits from voluntary redundancy programmes do not meet the criteria required to qualify for a tax exemption. Namely, the ministry highlighted that tax regulations provide no definition of 'compensation' and thus its meaning should be derived from civil law.

According to civil case law and legal writers, the notion of 'compensation' or 'damages' is predominantly understood as remuneration for unlawful damage caused to another party. Civil law associates the obligation to provide compensation with the following prerequisites:

- an event which results in the obligation to provide compensation;
- the existence of damage; and
- the causal link between the event and the damage.

As a result, the obligation to provide compensation is linked with liability for breach of contract or liability for tort. Where there is no breach of contractual duty or tortious activity, there can be no *bona fide* compensation.

## AUTHORS

[Filip Sodulski](#)



[Bartłomiej Biały](#)



Based on the above, the Ministry of Finance has pronounced that benefits payable to employees under voluntary redundancy programmes do not constitute compensation, regardless of being defined as compensation under relevant collective agreements or employer regulations.

## **Comment**

The general interpretation will most likely have a significant impact on the tax authorities' future practice. It is surprising that the tax authorities had not previously explored in depth the above interpretation regarding the legal substance of compensation, as referred to in Article 21 of the Personal Income Tax Act.

Polish legal writers specialised in employment law have long adopted the notion that only remuneration which aims to provide relief to an employee for an employer's unlawful acts or omissions can be considered as compensatory.

Conversely, a benefit payable to an employee under a voluntary redundancy programme is the result of an employee's decision to join such a programme and, consequently, receive additional financial compensation for the voluntary termination of his or her employment agreement. In this scenario, no breach of contract or tort can be attributed to the employer. Termination of employment by mutual consent under a voluntary redundancy programme is universally considered to be a legitimate method to end an employment relationship.

Further, a voluntary redundancy benefit is remuneration similar to statutory severance for the termination of employment for reasons unrelated to an employee (eg. collective redundancies). The latter, in turn, does not benefit from Article 21's tax exemption.

The Supreme Court has ruled that voluntary redundancy benefit may be considered an additional severance payment. In the court's view, these payments are more similar to standard remuneration for work rather than compensation. Their aim is to provide the employee with means of support and to satisfy other needs, whereas the main purpose of compensation is to indemnify the employee for any damage incurred.

Voluntary redundancy benefit cannot be changed by simply referring to such a payment as 'compensation' in a collective agreement or an employer's regulation, whereas this wording seemed to encourage the tax authorities to adopt a favourable approach in previous individual tax rulings issued regarding similar employee benefits.

The practical impact of the Ministry of Finance's general interpretation will most probably lead to the unification of the tax administration's future practice regarding the taxation of voluntary redundancy benefits.

In practice, this means additional obligations and potential liability for companies which perform voluntary redundancies. Namely, for the time being, such employers can simply transfer the amount of voluntary redundancy benefit into an employee's bank account, as such payments are exempt from social security contributions and personal income tax.

However, in future, employers will likely be responsible for calculating, collecting and paying the personal income tax for an employee's voluntary redundancy benefit. Any fiscal liability for breach of such obligation will rest with the employer.

*For further information on this topic please contact [Filip Sodulski](#) or [Bartłomiej Biały](#) at [Soltysiński Kawecki & Szlęzak](#) by telephone (+48 22 608 7000) or email ([filip.sodulski@skslegal.pl](mailto:filip.sodulski@skslegal.pl) or [bartlomiej.bialy@skslegal.pl](mailto:bartlomiej.bialy@skslegal.pl)). The [Soltysiński Kawecki & Szlęzak](#) website can be accessed at [www.skslegal.pl](http://www.skslegal.pl).*