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## **UNREVEALED SOURCES OF REVENUE – DISCLOSURE AND TAXATION PROCEDURES IN POLAND**

### **1. Introduction**

The existence of the shadow economy is regarded as one of the main factors contributing to decreased efficiency of a tax system. It is estimated that in Poland the so-called grey sector accounts for between 14.0%<sup>1</sup> and 27.3% [Schneider 2007, p. 19] of GDP. It covers profitable activity which is not always of a criminal nature, but is conducted without adhering to applicable legal standards, and in particular without paying the requisite taxes and other levies due to the state. It is taken to involve both registered taxpayers who understate their income, as well as unregistered entities failing to report income from taxable sources.

Tax fraud prevention is a priority of European Union policy. EU Member States are undertaking a wide range of coordinated initiatives in this area. This concerns in particular evasion of taxes imposed on businesses (CIT and VAT). However, in relation to personal income tax fraud, preventive action is usually taken at a purely national level. In Poland numerous instruments are applied to limit the scale of the fraud in question. They include both legal regulations, such as the Act of 16 November 2000 on counteracting introduction into financial circulation of income and assets derived from illegal or unrevealed sources and on counteracting the financing of terrorism,<sup>2</sup> as well as means of an organizational nature aimed at improving the efficiency of fiscal inspections, e.g. the inclusion of income from unrevealed sources under the areas of external risk used as a basis for

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<sup>1</sup> According to Central Statistical Office. For further details see [*Praca nierejestrowana...* 2005, pp. 1-56].

<sup>2</sup> *Dziennik Ustaw* Nr 116, poz. 1216 as amended.

targeting such inspections [“Zadania dla urzędów...” 2007, p. 3]. Instruments serving these goals also cover the 75% fixed rate of taxation on income from unrevealed sources of revenue or income understated in declared sources.

The article gives an overview of the taxation procedures applied in Poland to the afore-mentioned income. It focuses on two main issues. First, it presents the methods of personal income fraud detection – tax and fiscal inspections as well as information collection measures. Secondly, it describes proceedings concerning the assessment of tax on the income in question. Moreover, the author evaluates the effectiveness of the activities undertaken in this regard by tax offices and fiscal inspection offices on the basis of the data published by the Supreme Chamber of Control in Poland.

## 2. Targeting personal income tax evasion

Tax offices and fiscal inspection offices in Poland are committed to identifying and auditing potential fraudsters. Furthermore, they have a prerogative to assess tax on income from unrevealed (undisclosed) sources or income not covered by disclosed sources.<sup>3</sup> These authorities collect so-called indicative information about individuals suspected of concealing their income, making use of various internal and external sources. This information is gathered if a person incurs a one-off expense of 100 000 złoty or more, or several items of expenditure over a short time which total at least 100 000 złoty. It also applies to taxpayers whose expenditure is significantly disproportionate to their declared income. A special organizational unit of the tax authority, dealing with the taxation of income not covered by revealed sources, is obliged to keep a systematic set of indicative information, arranged in alphabetical order. Moreover, this information is retained for a period of at least six years from the end of the tax year in which the expenditure in question occurred. This period is a consequence of the time limit on assessment of tax on income from unrevealed sources, as laid down in Polish Tax Ordinance.<sup>4</sup> In a situation where a person’s single expense or sum of expenditure exceeds 250 000 złoty, the tax authority forwards the indicative information to the fiscal inspection authority.

An internal source of information about individuals suspected of concealing their actual income is the electronic databases of the tax authorities, including in particular the *Poltax* system (together with the *RemDat* system which enables the fiscal inspection authorities to access the *Poltax* data), and its subsystems called

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<sup>3</sup> Article 5(6)(1) of the Act of 21 June 1996 on tax offices and tax chambers, *Dziennik Ustaw* 2004 Nr 121, poz. 1267 as amended and Article 2(1)(2-3) of the Act of 28 September 1991 on fiscal inspection, *Dziennik Ustaw* 2004 Nr 8, poz. 65 as amended.

<sup>4</sup> According to that law, there is no tax liability on income not covered by disclosed sources of revenue or coming from unrevealed sources if the decision determining the liability delivered after 5 years has elapsed from the end of the year in which an annual personal income tax return should have been submitted for the tax year to which the decision relates. See Article 68(4) of the Tax Ordinance of 29 August 1997, *Dziennik Ustaw* 2005 Nr 8, poz. 60 as amended.

*Egapoltax* (concerning enforcement actions), *Kontrola* (concerning tax inspections) and *CzM* (concerning financial transactions). The *Poltax* system and the *CzM* subsystem contain data declared by taxpayers in their tax returns. The *Egapoltax* system, relating to administrative enforcement proceedings, records among other things data included in reports on material status drawn up in the course of enforcement procedures. The *Kontrola* subsystem serves, inter alia, to record data contained in post-inspection reports.

External sources of information about individuals suspected of obtaining income from unrevealed sources cover data from courts, stockbrokers, banks, court enforcement officers, notaries, car dealers, local authority offices, trust funds, insurance companies, the Social Insurance Institution (ZUS), police, the Internal Security Agency (ABW), and information from the media, anonymous reports and complaints. The obligation to supply tax-related information to the tax authorities results from Articles 82, 82a and 83-86 of the Tax Ordinance [Babiarz 2006, p. 367]. In addition, the tax authorities make use of the following external sources: export and import records from the Foreign Trade IT Centre, registers of foreign currency brought into the country kept by customs offices, the databases of the customs services, and the National Court Register (KRS) and Land Register.

In identifying individuals suspected of obtaining income from unrevealed sources, the tax authorities focus, among other things, on persons categorised as high risk. These are principally persons investing significant sums (e.g. on the property market or stock exchange), having accounts in foreign banks and purchasing goods of significant value, as well as shareholders in corporations, owners of recently formed businesses, persons constantly declaring losses or low income from business activity, or closing their business after a short period of activity and then setting up new firms in the same or related economic sectors, persons not declaring any income, persons lending their names to others' businesses and those taking part in fictional transactions or collaborating with corporations located in tax havens, and members of criminal groups and their families. This category also includes persons having access to financial information (e.g. chairmen of housing cooperatives, members of committees running tender procedures), administrative officials of central and local government, and members of certain professions (such as lawyers, doctors and court experts).

The tax authorities examine and evaluate collected indicative information. After initial selection of such information they make a decision to take further steps or to close the case at the stage of internal information gathering. The selection of information is carried out without the participation of the taxpayer, since the verification activities with the involvement of the taxpayer, as referred to in Article 272 of the Tax Ordinance, do not apply to matters relating to unrevealed sources of revenue [Brzeziński, Kalinowski 2007, p. 653]. Possible further action which a tax authority may take after completing the selection involve undertaking an inspection and/or commencing proceedings to assess tax on income from undisclosed sources.

### 3. Tax and fiscal inspection as an anti-fraud measure

Tax authorities in Poland are entitled to carry out an inspection, inter alia, in order to determine a taxpayer's actual sources of revenue, the amount of his income, the reliability of the book-keeping devices he uses, the completeness of his accounting records and the sources of financing for his expenditure. The rules on conducting tax inspection are laid down in the Tax Ordinance, while those relating to fiscal inspection can be found chiefly in the Act on fiscal inspection (or, in matters not regulated there, in the Tax Ordinance). Additional regulations relating to the conduct of tax and fiscal inspection are contained in the Act on freedom of business activity.<sup>5</sup> Tax inspection has the aim of checking whether the inspected party meets the obligations arising from tax law. Fiscal inspection, on the other hand, is a type of state inspection performed by legally appointed authorities and serves to protect the financial interests of the State Treasury – one of its main functions is to combat economic crime. For this reason the scope of fiscal inspection is wider than that of tax inspection [Matysiak 2008, pp. 12-13]. It should be noted, however, that the inspection procedure is largely similar in both cases. Regardless of their objectives, tax inspection and fiscal inspection are conducted according to uniform principles.

A tax inspection takes place following the delivery of an authorization to the inspected party (or to an individual authorized to represent that party in the area of tax inspection), and the showing of official identification card. Fiscal inspection is executed in the form of inspection proceedings and fiscal inquiry. Inspection proceedings can be initiated only *ex officio* on the basis of a decision issued by the director of a fiscal inspection office or the General Fiscal Inspector. Fiscal inquiry involves the gathering, processing and use of information about persons and about the income, turnover, property and material status of parties subject to fiscal inspection.

Irrespective of the type of inspection, inspectors have a number of entitlements. These include the statutory right to enter land, buildings and other premises of the inspected party, to demand explanations, data or relevant information as well as, presentation of the assets subject to inspection and to examine them, in particular if information has been received about conduct of business activity that has not been reported for taxation purposes. Moreover, in relation to taxpayers conducting business activity, the authority may demand access to files, books and all types of documents relating to that activity, and may also question witnesses and seek the opinion of experts. In addition, tax authority conducting an inspection is entitled to take duplicates, photocopies of documents, items, samples and other necessary substances that have direct relevance to the aims of the inspection. Where

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<sup>5</sup> Act of 2 July 2004 on freedom of business activity, *Dziennik Ustaw* Nr 173, poz. 1807 as amended.

suspicion of concealing an income arises tax authorities generally determine the financial status of the taxpayer in the period subject to inspection. Pursuant to Article 33a of Act on fiscal inspection and Article 182 of the Tax Ordinance, tax inspection and fiscal inspection authorities may demand information from banks about the bank accounts held by the inspected party especially data concerning opening and closing balance as well as the statement of movements on those accounts. If the evidence collected in the course of tax or fiscal inspection confirms that expenditure is not justified by the income declared by the taxpayer, it is the taxpayer's duty to demonstrate that the questioned expenditure is covered by reported income and funds possessed.

Drawing up of an inspection report and its delivery to the taxpayer terminates a tax inspection [Szczypiór 2009, p. 112]. In case of fiscal inspection, the delivery of a report completes the inspection actions, while the inspection proceedings end with a decision determining or establishing tax liability, a final decision (in a situation where assessment is time-barred) or result (if no irregularities were detected). If the inspected party disagree with the findings contained in the inspection report, that party has the right to submit objections or clarifications within 14 days of the date of delivery of the report, at the same time indicating evidence and witnesses supporting them. Moreover, a taxpayer accepting the irregularities determined in the report or decision as justified may, following the completion of the inspection, under the procedure of Article 81b(1) of the Tax Ordinance or in accordance with Article 14c of the Act on fiscal inspection, correct previously submitted tax returns. If the tax office begins proceedings based on the findings of the tax inspection, that right is suspended for the duration of the proceedings. However, this does not deprive the taxpayer of the right to correct declarations after the proceedings end but before the issuing of a decision determining or establishing the tax liability.

#### **4. Proceedings concerning tax assessment on income from unrevealed sources**

Tax proceedings are undertaken by tax offices against individuals suspected of obtaining income from unrevealed sources of revenue or income not justified by reported sources, based on indicative information or the findings of a tax inspection. In case of such proceedings the burden of proof rests with the authority conducting them. That authority, in order to demonstrate that a taxpayer received an income not declared for taxation in the period subject to verification, should present evidence to support its position that the expenditure incurred by the taxpayer in the year in question is not justified by the income and assets accumulated in the tax year and in previous years from taxed or tax-exempt revenue. For this purpose it may demand that the taxpayer submit a declaration on the amount and sources of income obtained, expenditure incurred and material status at a specific date indicated in the summons.

In the course of the proceedings a taxpayer presents proof documenting the declared facts. For example, when claiming to have obtained an income from a loan, gift, work abroad, tax-exempt or non-taxable income, the taxpayer is obliged to present evidence in the form of witness testimony, bank transfer documents, customs declarations on the bringing of foreign currency into the country. In case of any doubt as to the truth of the facts declared, the tax authority may use its right to obtain information from other entities (such as banks, foreign tax authorities or foreign employers). The evidence collected by tax authorities can be freely evaluated, which may be to the taxpayer's disadvantage, as these authorities determine the value of certain categories of expenditure based on statistical averages.

If the tax authority is unable to establish an excess of expenditure over revenue, the proceedings are discontinued by force of law as being without substance [Bartosiewicz, Kubacki 2008, pp. 750-752]. Otherwise the tax authority has the right to issue a decision determining the tax liability or establishing the tax liability. If the tax authority detects irregularities in the disclosure and reporting of income a decision determining the tax liability is issued. The personal income tax liability is then calculated by the tax office on the basis of the tax rates applicable in the year to which the liability relates.

In other situations Article 30(1)(7) of the Act on personal income tax applies, according to which an income not covered by disclosed sources or coming from unrevealed sources is not combined with an income from other sources.<sup>6</sup> The income coming from unrevealed sources or not covered by disclosed sources is established by the tax authority on the basis of the expenditure incurred in the tax year and the value of property accumulated in that year and taxed at a 75% rate.<sup>7</sup>

A taxpayer who received a decision determining a tax liability is obliged to pay the tax (usually underpaid in the first place due to the under- or misreporting of income), calculated by the tax authority together with statutory interest for the delay, counted from the day following the deadline for payment of the tax. A decision establishing a tax liability as opposed to decision determining a tax liability is of a constitutive nature [Zdanowicz 2000, p. 12]. As a result of this a taxpayer to whom such a decision has been delivered is obliged to pay the due amount within 14 days of the date of receipt of the decision. Statutory interest for late payment is charged as from the day following this deadline. It should be noted that, according to Article 304 of the Code of Criminal Procedure,<sup>8</sup> if there are grounds to believe that the taxpayer's revenue may have come from criminal

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<sup>6</sup> Act of 26 July 1991 on personal income tax, *Dziennik Ustaw* 2000 Nr 14, poz. 176 as amended.

<sup>7</sup> The tax authority issues a decision establishing the personal income tax liability only when it is found in the course of tax proceedings, that the revenue has been obtained from unreported sources in a situation where the taxpayer does not wish to report them to the tax authority and the expenditure incurred confirms their existence [Pietrasz 2007, p. 123].

<sup>8</sup> Code of Criminal Procedure – Act of 6 June 1997, *Dziennik Ustaw* Nr 89, poz. 555 as amended.

activity, the tax authority is obliged to submit to the prosecuting authorities a notification of a potential crime, which may lead to suspension of the proceedings analysed until the issue is resolved by another authority or court. This relates to Article 2(1)(4) of the Act on personal income tax, which stipulates that this Act does not apply to income obtained from illegal activities [Kulicki 2005, p. 10].

## 5. Efficiency of applied fraud detection measures

The Supreme Chamber of Control (NIK) in Poland is empowered to audit all the activities undertaken by tax authorities, amongst others in order to analyse the legality, purposefulness and efficiency of the measures, employed by these authorities, aimed at tackling personal income tax evasion.<sup>9</sup> The results of audits in this area carried out in 2005-2006 and the first half of 2007 demonstrate that the system of taxation of income from unrevealed sources of revenue in Poland is costly and highly inefficient. Low efficiency was identified in particular in the process of verifying indicative information. In view of the large amount of work involved, tax offices analysed just 26-30% of indicative information registered in the period under investigation, and fiscal inspection offices included only 36% of cases in their inspection plans. Moreover, Poland's tax offices issued 1411 decisions and the fixed-rate tax established in those decisions equalled 78.9 million złoty. Of the total number of cases related to indicative information collected by tax offices, only 0.14% ended with the assessment of fixed-rate tax. The fiscal inspection authorities assessed an amount of 189.4 million złoty of fixed-rate tax, through 1196 decisions issued. In case of those authorities, a relatively low proportion of decisions were upheld in appeal proceedings. In the period in question 531 decisions, for a sum of 66.5 million złoty, were upheld, which is just 35.1% of the entire amount of fixed-rate tax assessed. This means that upheld decisions accounted for only 5.1% of the total number of cases available for analysis.

Supreme Chamber of Control carried out detailed audits of 19 tax offices and 9 fiscal inspection offices, the subject of audit being those offices' performance of their duties in relation to taxation of income from unrevealed sources of revenue in 2005, 2006 and the first half of 2007. According to the data presented in Table 1, the inspected tax offices had analysed 24.1% of the recorded indicative information. Only 12.4% of that information was forwarded to other tax offices according to geographical jurisdiction or to fiscal inspection offices in view of the size of sums involved. Moreover, they put aside 4.8% of the information without investigation on grounds of time-barring. At the end of the inspection period, 58.3% of the indicative information collected by the inspected offices remained to be investigated. Only in 454 cases proceedings were commenced, and the number of decisions

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<sup>9</sup> See Article 2(1) of the Act of 23 December 1994 on the Supreme Chamber of Control, *Dziennik Ustaw* 2001 Nr 85, poz. 937 as amended.

issued was 79. These resulted in the assessment of about 3.6 million złoty of tax. Three-quarters of the decisions issued went to an appeal body, and of these just over half were overturned. The amount of tax corresponding to the overturned decisions equalled nearly 1.2 million złoty.

Table 1. Results of audits conducted by Supreme Chamber of Control in selected tax offices in relation to activities concerning the assessment of tax on income from unrevealed sources

Indicative information registered by tax offices	35555
Indicative information analysed by tax offices	8585
Indicative information passed on to other tax offices and fiscal inspection offices	4424
Indicative information put aside on grounds of time-barring	1700
Indicative information left in tax offices at the end of audited period	20846
Proceedings initiated by tax offices	454
Decisions establishing tax liability issued by tax offices	79
Amount of tax assessed by tax offices	3606800
Decisions overturned	28
Amount of tax corresponding to the overturned decisions	1171200

Source: own study based on [*Informacja o wynikach...* 2008, pp. 13-21].

Table 2. Results of audits conducted by Supreme Chamber of Control in selected fiscal inspection offices in relation to activities concerning the assessment of tax on income from unrevealed sources

Requests and applications for inspection registered by fiscal inspection offices	5600
Requests and applications for inspection analysed by fiscal inspection offices	3800
Inspections initiated by fiscal inspection offices	1568
Decisions establishing tax liability issued by fiscal inspection offices	806
Amount of tax assessed by fiscal inspection offices	131600000
Decisions overturned	177
Amount of tax corresponding to the overturned decisions	23900000

Source: own study based on [*Informacja o wynikach...* 2008, pp. 21-27].

Figures in Table 2 indicate that in the period under consideration the fiscal inspection offices analysed 67.9% of requests and applications for inspection received from other authorities (e.g. from tax offices, public prosecutors' offices and police). Data are not available on the quantity of indicative information, not associated with a request for carrying out of an inspection received from tax offices. In case of 43.3% of inspection proceedings, decisions were issued establishing a fixed-rate tax liability, to a sum of approximately 131.6 million złoty. Appeals against these decisions were lodged by 702 taxpayers, concerning a total amount of 123.2 million złoty. Of this number, 22.0% of the decisions were overturned. The amount of tax corresponding to the overturned decisions equalled 23.9 million złoty.



## 6. Conclusions

The methods applied by Polish tax authorities aimed at the detection and elimination of personal income tax fraud are, in fact, inefficient. This results primarily from a misguided strategy for the selection of indicative information. In the period under consideration tax offices concentrated in particular on “old” indicative information, in order to avoid the time-barring of tax liabilities, without analysing the information recently acquired. Moreover, they were examining in the first place information where the amounts potentially lost to the state budget were small.

There was also significant negligence in the process of collecting and forwarding indicative information. It was collected not in accordance with the Finance Ministry’s guidelines, and forwarded with significant delays. It is not possible to evaluate the performance of fiscal inspection offices in this regard, in view of the absence of separate records of indicative information received from other tax authorities by these offices. This fact must be considered a serious fault in the functioning of the system being described. The cost of functioning of the system for taxation of income from unrevealed sources is disproportionately high compared with the results. In the investigated period the inspected tax offices allocated 2.7 million zloty for the salaries of employees working in this area, while for the fiscal inspection offices the figure equalled 45.8 million zloty.

Summarising it has to be underlined, that the institution of taxation of income from undisclosed sources of revenue makes only a very small contribution to the combating of personal income tax fraud. The creation of effective anti-fraud instrument is therefore a major challenge for legislators in Poland. Moreover, in order to obtain satisfactory results, tax offices and fiscal inspection offices should intensify their analytical and inspection activities.

Criticism should also be made of the legal regulations applicable in this area. It has to be noticed that erroneous recording of revenue in bookkeeping devices, for example through misplacement of figures, has the same tax consequences for a taxpayer as deliberate evasion of tax. The increased tax rate of 75% is applied only to those taxpayers who in the course of proceedings are not able to credibly indicate sources of revenue serving to account for all their expenditure in the year to which the tax proceedings relate.

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