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Payment of awarded liquidated damages

Tax Alert

Dear Readers,

On 17 January 2017, the Supreme Administrative Court issued a judgement (file ref. No. Act II FSK 3712/14) upholding the position of the Administrative Court in Gdansk dated 15 July 2014 (file ref. No. I SA/Gd 589/14), under which liquidated damages awarded to a company's CEO are subject to personal income tax as income from activities performed personally.

The case concerned a dismissed CEO of a company. In this respect, the District Court awarded liquidated damages to the CEO. The dispute with the tax authorities concerned the qualification of the revenue from the compensation received.

According to the CEO, the company paying the liquidated damages had unjustifiably deducted an advance on income tax. In his opinion, the funds received should be considered as income from other sources (Art. 20(1) of the Personal Income Tax Act of 26 July 1991 (consolidated text, Journal of Laws of 2016, item 2032; "PITA")) from which the advance should not have been deducted. The CEO believed, moreover, that the payment, as a kind of compensation, is subject to tax exemption under Art. 21(1) sub-paragraph 3b of the PITA.

The Administrative Court in Gdańsk did not agree with this position. The Court stressed that the source of the income earned was the earlier function as a board member and the fact of dismissal before the end of the term. Therefore, **for the purposes of income tax, the liquidated damages received by the CEO is income from activity performed personally.**

The Court also did not confirm that the liquidated damages may be considered as a kind of compensation that is exempt from taxation. The Court admitted that the liquidated damages are analogous to compensation but the difference is that liquidated damages are due to the creditor whenever there are circumstances justifying the accusation of non-performance or improper performance of an obligation, regardless of the value of incurred damage. The Court stressed that liquidated damages and compensation have a different meaning in spite of having a similar function. **As a result, the company paying the liquidated damages acted correctly by deducting the advance on income tax.**

The Supreme Administrative Court dismissed the cassation appeal of the CEO, thereby acceding to the position of the first instance court. Due to the lack of published justification, the reasons behind the decision are not known.

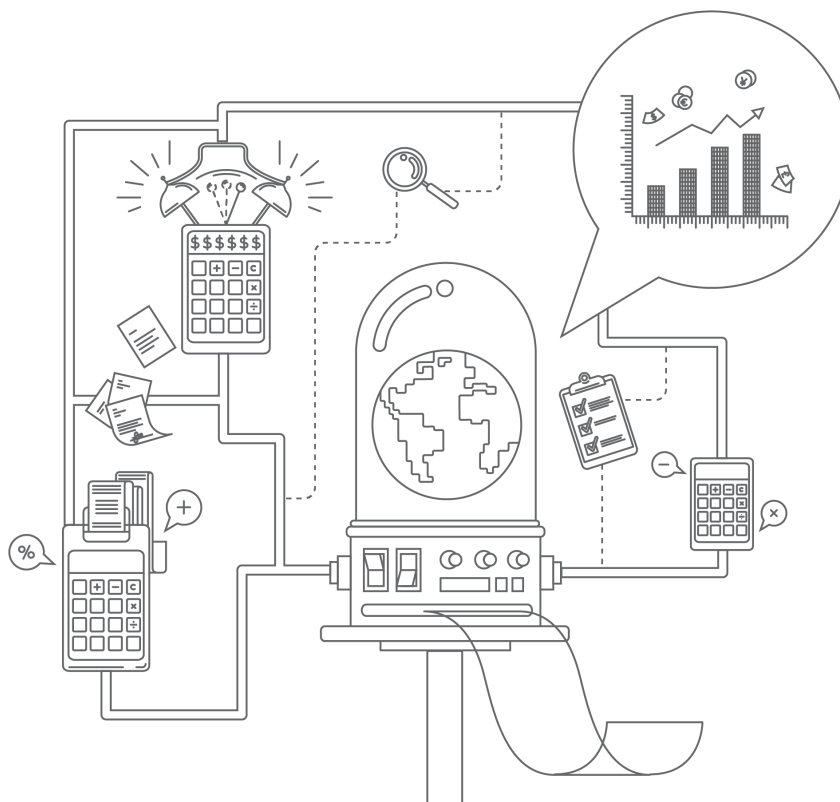
In practice, there are numerous situations in which board members removed from office enter into a dispute with the company for payment of compensation in this respect. These sentences are consistent with the practice of recognising compensation paid to former board members as income from activity performed personally. These judgements also indicate a difference in the treatment of liquidated damages and compensation. If the amount was paid as compensation for damage suffered, it would be subject to the tax exemption.

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Should you wish to discuss the above mentioned amendments in detail, feel free to contact us:

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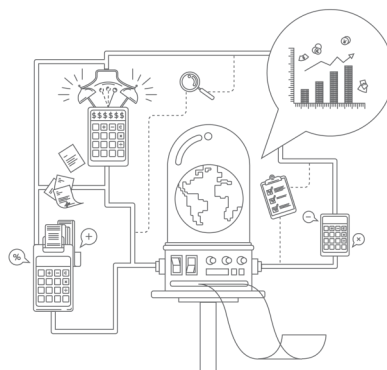
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