

The influence of the form of taxation on shaping cash flow

Małgorzata Kwiedorowicz - Andrzejewska¹

Abstract

The most important problem in the activities of business entities is achieving the highest possible gains. Since one of the factors which decrease profits is income tax, choosing the form of tax payment is, especially for small and medium entrepreneurs, of paramount importance. The aim of this paper is to present how the form of taxation, properly tailored to the form of business, can influence the owner's profits by increasing cash flow.

Key words

Taxation, tax scale, flat rate tax

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1 The forms of taxation of business activities in Poland.

In Poland there are a few forms of taxing enterprises depending on the size and volume of business, its legal form, the kind of business activity and the number of employees. Some enterprises are obliged to maintain comprehensive bookkeeping (large companies), but enterprises run by natural persons (one to a few employees) have a choice. In this paper I will especially concentrate on such companies.

The application of the admissible form of tax is determined by the organizational-legal form of business. The dependence is presented in Table 1, which shows the available organizational-legal forms and possible forms of tax. The symbol “+” means that this form of tax payment is possible for the given form of ownership.

In case of a company run by a natural person its incomes can be subject to taxation based on two acts:

The act on lump-sum taxation of certain kinds of revenue earned by natural persons, dated 20 November 1998.

Personal income tax act, dated 26 July 1991.

Within these acts we can distinguish four forms of taxation. Two lump-sum forms: flat rate tax and flat-rate tax on registered income without deductible costs and two general ones – pursuant to the tax scale (progressive tax) and pursuant to 19% rate (flat tax).

¹ Małgorzata Kwiedorowicz – Andrzejewska, Wrocław University of Economics

Table 1. Forms of enterprise ownership and admissible forms of taxation in Poland.

Form of taxation	Natural person/civil partnership	General partnership	Professional partnership/limited partnership	Limited liability company	Joint stock company
Flat rate tax	+	-	-	-	-
Flat-rate tax on registered income without deductible costs	+	+	-	-	-
General rules for natural persons – pursuant to the tax scale	+	+	+	-	-
General rules for natural persons – pursuant to flat tax	+	+	+		
Corporate income tax	-	-	-		-

Source: own elaboration.

A natural person conducting business activity may decide to apply the following forms of calculating income tax:

- General rules – the tax scale
- Flat tax
- Flat rate tax
- Flat-rate tax on registered income without deductible costs

1.1. General rules – the tax scale.

The rules of this basic form of taxation of natural persons in Poland are formulated in Personal income tax act, dated 26 July 1991.

The tax base is income (the difference between revenues and tax deductible costs) which can be reduced by social security premiums (paid with reference to a taxpayer or persons co-operating with the taxpayer), if they were not earlier included in tax deductible costs. Tax is calculated in compliance with the tax scale for a given year:²

² Personal income tax act, dated 26 July 1991.

Table 2. The tax scale for the year 2011.

over	to	tax
0	PLN 85,528	18 % minus amount decreasing the tax PLN 556.02
PLN 85,528		PLN 14,839.02 + 32 % of surplus over PLN 85,528

Source: own elaboration based on www.podatki.egospodarka.pl

In compliance with the scale, the amount of tax due is calculated according to the following scheme:

1. taxable income = revenues - tax deductible costs
2. income - social security premiums - carry forward losses - other tax allowances and deductions = tax base

The tax base shows which rates are to be applied to calculate tax:

3. the tax due (paid to the tax office) = tax - other tax allowances and deductions (e.g. the owner's insurance premiums) - advance tax payments made since the beginning of the year.

The advantages of applying taxation pursuant to the tax scale are as follows:

- Full control over the company's financial situation
- A possibility to settle carry forward losses by reducing income in the next years (5 years maximum)
- A possibility to establish one's own chart of accounts appropriate for a given business activity
- A possibility of tax exemption if we invest in an enterprise zone.

The disadvantages of this form of taxation are:

- A large degree of complexity
- Progressive tax scale which results in the relationship: higher income = higher tax
- Costly accounting
- An obligation to fulfil many additional requirements resulting from the accounting act.

1.2. Flat tax

Another form of taxation is flat tax. It can be chosen by natural persons conducting business activity on their own as well as partners in civil, general, professional and limited partnerships.

The decision on flat tax entails the obligation to notify the tax office. If a taxpayer launches his business activity such a notification should be given by the day preceding the launch and no later than on the day of earning first revenue.

Like in case of the tax scale, choosing flat tax as a form of tax payment means that the amount of tax due will be calculated from the income generated by the business. In other words, we will pay tax only if our activity is profitable, i.e. our revenues exceed costs.

The stages of calculating flat tax:

1. Income = revenues – tax deductible costs
2. Income – tax deductions (social security premiums, carry forward losses) = tax base

3. Tax = tax base*19%
4. Tax due = tax – health insurance (7.75% of tax base) – tax due for the previous months.

The advantages and disadvantages of this form of taxation.

The basic advantage of this form of taxation is one rate, which means that if we achieve high incomes (in case of taxation pursuant to the tax scale we pay higher tax) we still pay tax calculated in compliance with the same rate. At present the rate is 19%. Essentially, earning high incomes determines the advantages resulting from this form of taxation.

This form of taxation has also some disadvantages. When we use it, we lose some privileges which those who pay taxes in compliance with the tax scale enjoy. Deciding on flat tax we lose

- the possibility to file a joint income tax return,
- single parent tax credit,
- exemptions due to investments in enterprise zones,
- all tax reliefs

The taxpayers who decided to apply a flat-rate tax of 19% to their income from business activity, are subject to the general rules concerning submission of the annual tax statements. However, the PIT Act provides for a simplified form of calculation and payment of tax advances, i.e. in the amount of 1/12 of the tax amount shown in the tax return submitted to the tax office in the tax year preceding a given tax year (thus, tax advances for the year 2011 will be calculated based on the income earned in 2009, since the tax return for this year was filed in 2010). Detailed regulations of this form of payment of tax advances are explained in art. 44 par. 6b-6i of personal income tax act.³

1.3. Flat rate tax.

Flat rate tax is the simplest way to pay taxes since it does not require complex bookkeeping, and invoices are issued only on customer's request. The amount of this tax is announced by the head of tax office in advance each year. Flat rate tax is an alternative form of personal income tax (flat rate in the meaning of constant rate). It can be used by civil partnerships and natural persons conducting business activity.

³ Personal income tax act, dated 20 November 1998.

Table 3. Examples of flat rate tax rates for catering.

Catering without selling alcohol stronger than 1.5% proof	Symbols of rates	The amount of rate in zlotys
Selling ice cream cones	0	422-559
	1	559-736
	2	663-841
	3	771-944
	4	1038-1220
Other forms of catering	0	370-491
	1	491-682
	2	583-771
	3	697-875
	4	941-1152

1.1 Source: own elaboration based on www.money.pl

The formula for calculating tax paid in the form of flat rate tax:

Tax = monthly rate of flat rate tax – health insurance premium paid (7.75% of tax base)

Advantages of flat rate tax:

- No bookkeeping, no obligation to file tax returns or submit the declaration of income, and no advance tax payments,
- Paying a constant fixed flat amount of tax,
- The rates defined in the PIT act are decreased by 20% for people over 60, who are moderately or slightly disabled and who do not employ workers,
- A taxpayer has the right to suspend payments in case of temporary business stoppage lasting continuously for at least 10 days.

Disadvantages of flat rate tax:

- No possibility to file a joint income tax return,
- You cannot use services of people who are not your workers based on employment contract and services of other companies unless these are specialist services,
- To pay tax in the form of flat rate tax you have to fulfil a number of requirements concerning both the form of business and the number of employees.

1.4. Flat-rate tax on registered income without deductible costs.

Flat rate income tax is one of the available forms of paying taxes for natural persons conducting business activity. The flat rate is calculated according to the income earned and the basis of the calculation are the regulations of revenue account which we will be obliged to keep.

This form of taxation is available to natural persons, civil partnerships and general partnerships. It is also available to people who:

- in the preceding tax year earned an income of less than €150,000.

- were refused the possibility of applying flat rate tax
- relinquished the taxation in the form of flat rate tax within 14 days from receiving the decision concerning the amount of tax due
- will inform in due time the tax office of the fact that they no longer meet the requirements of flat rate tax

Deciding on a lump sum, an entrepreneur pays tax irrespective of whether the company generates any profits. At the same time, if the business is highly profitable, the tax paid will be considerably lower than if the owner paid taxes in compliance with the general rules (flat tax or pursuant to the tax scale).

The rates of flat-rate tax on registered income

- **20%** - revenues from freelance occupations
- **17%** - revenues from performing services: hotels, parking lots, car rental, computer hardware consulting, wholesale and car sales agencies, real estate management
- **8.5%** - revenues from performing services: lease, sublease, tenancy, subtenancy, fighting and preventing fires, the factor's commission from sales, performing services relating to botanical gardens
- **5.5%** - revenues from manufacturing activity, construction works, transport of goods by means of fleet of allowable load capacity over 2 tons, commission from selling public transport tickets and postage and revenue stamps
- **3%** - revenues from catering trade except for revenues from selling alcohol stronger than 1.5% proof, services connected with livestock production, sea and lagoon fishing and selling fish and other catch except for selling tinned fish⁴.

The lump sum due is calculated as follows:

the lump sum due = (revenue – deductions from revenue – social security premiums)

the lump sum rate – health insurance premium – tax deductions

Revenue may be reduced by e.g.: the loss incurred in the previous tax year (if the taxpayer paid personal income tax in compliance with general rules), the expenses for rehabilitation of disabled persons, the expenses incurred for the use of the Internet, donations for public utility organisations, donations for religious purposes and blood donations.

Advantages of flat-rate tax on registered income:

- no obligation to file monthly tax returns
- a taxpayer pays turnover tax, which may be more profitable than in case of tax payment in compliance with general rules
- less complicated bookkeeping

Disadvantages of flat-rate tax on registered income:

- there is no possibility to recognize expenses against the costs of income acquisition
- the lump sum is sometimes too high compared to the margins achieved

⁴ www.kosztywfirmie.pl

- this form of taxation cannot be renounced during a tax year (and if a taxpayer does something which by law may not be taxed in this way, he loses the right to this form of tax payment)
- there is no child tax credit

2. The calculation of tax with the use of available forms of corporate income tax payment.

Deciding on one of the available forms of tax payment we can choose a form which will allow us to pay the lowest possible tax and will, as a result, increase cash flows and, consequently, the owner's profits.

Example:

A natural person wants to choose the most favorable form of taxation. Let's assume that the company's annual incomes are PLN26,400, which makes it possible to choose any form of tax payment. It is a one-man catering business. In future the owner plans to increase the number of workers and to increase the company's assets.

2.1. The calculation of tax pursuant to the tax scale.

- annual income: PLN26,400
- the income is reduced by social security premiums: $26,400 - 12 \cdot 530.20 = 20,037.60$
- we calculate the tax pursuant to 18% tax scale: $18\% \cdot 20,037.60 - 556.02 = 3,050.57$
- the tax is reduced by the owner's health insurance premiums: $3,050.57 - 12 \cdot 215.35 = 467$

The amount of tax due calculated in compliance with the tax scale is PLN467.

2.2. The calculation of tax pursuant to flat tax.

- annual income: 26,400
- the income is reduced by social security premiums: $26,400 - 12 \cdot 530.20 = 20,037.60$
- annual tax is $19\% \cdot 20,037.60 = 3,807.14$
- the tax is reduced by the owner's health insurance premiums:
 $3,807.14 - 12 \cdot 215.35 = 1,223$

Deciding on flat tax, our annual tax is PLN1,223.

2.3. The calculation of tax pursuant to flat rate tax.

Here, the amount of tax can be read from Table 3 of the lump sum tax act. The rates of tax paid in this way are set by the head of the competent tax office based on the tax return form PIT-16 filed by the taxpayer and the amounts included in annex 3 to the act on lump-sum taxation of certain kinds of revenue earned by natural persons, dated 20 November 1998. The rates are increased annually to account for the increase in prices of consumer goods and services during the first three quarters of the tax year compared to the same period of the previous year.

- monthly tax is 420.50
- annual tax is $420.50 \cdot 12 = 5,046$
- the tax is reduced by annual health insurance premiums: $5,046 - 12 \cdot 215.35 = 2,462$

The amount of tax due calculated in compliance with flat rate tax is PLN2,462.

2.4. Flat-rate tax on registered income

Based on the kind of business activity, the tax office decided that an entrepreneur has to pay a 3% flat rate. In this case we calculate the tax due as follows:

- the revenue is reduced by the entrepreneur's social security premiums
 $26,400 - 12 \cdot 530.20 = 20,037.60$
- the amount of tax: $3\% \cdot 20,037.60 = 601.13$
- the tax is reduced by health insurance premiums: $601.13 - 12 \cdot 215.35 = 0$

Here, the company will pay no tax.

We can do similar calculations based on different parameters. Let's assume that we increase the number of workers by one person in each of the above simulations. In the fourth scenario there appears another element – fixed assets, so we can expect benefits resulting from depreciation allowance.

Table 4. The value of tax and the number of workers.

Form of taxation	Annual tax for 1 worker	Annual tax for 2 workers	Annual tax for 3 workers	Annual tax for 4 workers
General rules – the tax scale	467	1,115	10,619	16,642
Flat tax	1,223	1,907	11,939	16,271
Flat rate tax	2,462	4,460	5,540	6,848
Flat-rate tax on registered income	0	105	2,625	4,785

Source: own elaboration.

From the above calculations it follows that the most favorable form of paying taxes is flat-rate tax on registered income, which is a consequence of low taxable incomes and the kind of business activity. In case of freelance occupations this form of tax payment is not as favorable, since here the lump sum is 20%. This means that paying tax in the form of lump sum will be more favorable only if revenues exceed the threshold of PLN85,528.

The amount of tax influences cash flows, which results from the basic principle of evaluating cash flows:

net profit + depreciation – tax +/- changes in working capital requirements +/- other cash inflows and outflows. Since tax is definitely a category which decreases cash flow, it is obvious that the lower the tax, the more free financial resources the owner has at his disposal.

Summing up, deciding on the right form of taxation has a big influence on the amount of tax, which, in turn, influences cash flows and the benefits for the owner. We should not only very carefully choose the form of tax payment when launching a business activity, but also, conducting such an activity, analyze the situation and if necessary be ready to change the form of taxation, notifying the tax office about our decision.

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