

Tax Newsletter



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Dear Sir or Madam,

Welcome back after holiday to a new issue of our Newsletter.

In the current issue we would like to attract attention especially of those of you whose firms carry out the import of goods by a company not being its owner – please have a look at our tax commentary on this matter.

Some important judgments have been rendered recently with respect to settlements between local related entities which give us an insight on what is the current approach of authorities and courts to the examination of transactions between related parties and the assessment of its market nature. Information about the circumstances of this case and judgments as well as practical conclusions for taxpayers are discussed further in the Newsletter.

On this occasion, I would also like to tell you about the business breakfast organized by Mazars Tax Advisory Department which is planned for 27th October 2011 “VAT: recent issues related to tax on goods and services – along with presentation of amendments made and planned for 2011”. The breakfast will be moderated by Kinga Baran. We will inform you of the programme and conditions of participation in a separate email.

Yours faithfully,
Krystyna Szydłowska

EDITORIAL

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VAT: Import of goods by a company being a non-owner

In practice, it often happens that for different business reasons the importer of goods is not their final owner (e.g. a Polish company attends to customs formalities on behalf of a foreign-based company which is not registered in Poland or imports goods for its foreign parent company or the delivery of goods is chain-like and is made to a different address than their final recipient).

Invoices issued by entities carrying out this kind of import are most often reflected in the way customs documents are drawn up – third-country exporter issues a sale invoice to a Polish company which is formally their importer (as it results from customs documents). Then, the Polish company – after import of goods is completed – issues a sales invoice to the final recipient of goods for whom they were originally intended.

However, this way of importing goods (in which 3 entities are actually involved) leads often to misunderstandings. For instance, the initial invoice (issued by the exporter) to the importer – already after import is made – is sometimes cancelled by the supplier by issuing the proper invoice – to the company which is eventually the owner of goods. If the owner of goods (third party) records the acquisition of goods based on the invoice issued by exporter, the entity which formally imported the goods will not be able to “re-invoice” the delivery of goods (the final recipient already has an invoice – issued by the exporter – which was not however, the basis for issuing customs documents to the importer).

In such situation, taxpayers (importers) often do not know how to proceed – in the majority of cases they want to adjust SAD form so as to have it issued to the entity which is the owner of goods. Customs authorities refuse to make the adjustment (due to the fact that the initial sale invoice had been issued to the importer who paid all the customs duties and tax dues). After cancelling this invoice – once the import is made – the importer does not have any invoice which would confirm his right to the goods purchased from a third country. The importer is not formally the owner of goods which he imported. Therefore, he does not know whether he can deduct the input tax on the import of goods. The invoice is not crucial for the import, which is something taxpayers tend to forget; the import of goods is evidenced for VAT purposes only by customs documents. It is confirmed by article 86 section 2 point 2 of the VAT Act, according to which the amount of input VAT in the case of import of goods is the total of taxes resulting from customs document and import declaration (in other cases it is a VAT invoice received from the seller). Furthermore, import of goods is defined as transport of goods from a third country to the territory of the country. This means that the activity consisting in the import of goods is separated from the sale (purchase) of goods as such. Therefore, this activity is not necessarily based on – although generally this is the case – **transfer of the right to administer goods as an owner** (it is not necessary to purchase it from the seller and to be its owner).

Furthermore, in line with the general rule (art. 86 section 1 of the VAT Act), the taxpayer has the right to reduce the output VAT by deducting the input VAT to the extent to which the goods and services are used to **carry out taxable activities**. The import of goods itself is a taxable activity, so the input VAT on the import of goods can be deducted in any case – even if the imported goods (and not the purchased goods) are not used in the business of the taxpayer.

International tax law:

Amendment of the Double Taxation Avoidance Agreement with Cyprus

According to the information announced by the Ministry of Finance, the Agreement between the government of the Republic of Poland and the government of the Republic of Cyprus for the avoidance of double taxation with respect to taxes on income and on capital drawn up in Warsaw on 4 June 1992 (Journal of Laws of 1993, No. 117, item 523) hereinafter "the Agreement" was renegotiated at the beginning of May.

The Cypriots accepted the protocol relating to amendments to the Agreement proposed by the Poles and covering mainly changes regarding the deduction of Cypriot tax from the dividend income and taxation of directors' remuneration. The Ministry of Finance announced the ratification of the protocol already this year and its coming into force on 1 January 2012 (at the latest on 1 January 2013). Hence, the procedure of getting approval from the Council of Ministers to sign the protocol has already started. The whole range of modifications resulting from the protocol has not been unveiled to public yet.

Nevertheless, considering the present wording of the Agreement it is to be expected that those changes will aim at modifying the method of avoidance of taxation applicable to income subject to taxation at source (in Cyprus); i.e. interest income, dividend income and royalties. Currently, Polish tax residents declaring the above income in Poland are entitled to deduct from the output VAT on this income the amount of tax at source that could be levied by the Cypriot authorities under the Agreement (i.e. 10% - for dividends and interest, 5% - for royalties), even if in fact this tax was not paid in Cyprus at all. Hence, in Poland the effective taxation of dividends paid by a Cypriot company to a Polish resident is 9%. This rate results from deducting 10% of the value of dividend (10% represents the tax at source that could be levied by Cypriot authorities in line with the Agreement) from 19% of the value of dividend (19% represents the tax imposed on dividend income in compliance with the Polish internal laws).

As a rule, double taxation avoidance agreements signed by Poland with other countries with respect to interest income, dividend income and royalties provide for application of a so-called proportional tax credit method. In brief, it consists in the fact that a Polish resident can deduct from the output tax on this income in Poland only the amount of tax that was actually paid in the source country. It may imply that after the coming into force of the protocol to the Agreement, Polish residents will be obliged to apply this method with respect to the above-mentioned income. Then, non-payment of the Cypriot tax at source would entail the lack of possibility to make any deduction from output tax (in Poland) on this income.

Another planned change concerns principles of taxation of remuneration of directors being Polish residents for performing their functions in the companies registered in Cyprus. At present, this income in most cases is exempt from taxation at source in compliance with the internal laws of Cyprus. At the same time, in line with the Agreement this income is also exempt from taxation in

Poland (its value is taken into account only for calculating the tax rate applicable to income subject to taxation in Poland according to taxation bracket, if such income is earned at all). And until the protocol is unveiled, it is difficult to say without ambiguity in what way the Ministry of Finance has decided to change the above - beneficial for directors - method of taxation. Therefore, the taxpayers interested in this issue have to wait until the protocol is made known to the public and comes into force – we will keep you informed on this matter.

Despite the planned amendments to the Agreement, which will greatly limit the above-described benefits resulting from preferential taxation of dividends and remuneration of directors, Cyprus will remain attractive to Polish investors due to other, unchanged facilities of the Cypriot law, among others, tax exemption of income on capital gains (sale of shares/stocks, dividends, gains on other securities) earned by companies based in Cyprus.

CIT / Transfer pricing: Settlements between related parties under the magnifying glass

The judgments rendered recently by the Regional Administrative Court in Białystok, explicitly show that tax authorities during their inspections examine more and more thoroughly settlements between the related entities. They analyse in detail the manner of determining prices, especially facing the changing market conditions and examine the actual dates and conditions of payment. In the case of local transactions also the financial results of the activity run by all local entities involved in given transactions are subject to control of tax authorities, in particular from the point of view of their fiscal result over several fiscal years.

The above-mentioned judgments of the Regional Administrative Court in Białystok of 12 July 2011 (ref. I SA/Bk 158/11 and I SA/Bk 217/11) pertained in particular to re-estimation of the income by tax authorities which resulted in a significant decrease of the loss declared by the Company in one of the controlled years and arising of a tax liability (and determining the amount of interest for delay in payment of advances) instead of a declared loss in another period subject to control.

Upward adjustment of income of an entity producing dairy products purchased mainly by a local related entity (distributor), resulted principally from application of non-market – according to tax authorities - conditions of payment (selling prices and payment periods) to the transactions with the related party.

The main reason for considering the nature of the examined transaction as non-market was that the prices of the sold products were determined in a given year, without taking into account a significant rise in prices of raw materials used for production. By the same token, income earned from the sale of products by the producer did not cover its costs of production (the most significant component is the buying price of materials). Please note that not only the return on transactions was subject to examination of tax authorities but also the detailed cost structure of the producer. In the rationale quoted in the judgments the court relies on comparable data obtained by the

authorities during their inspection concerning the mechanism of calculation of prices applied by the entities operating in a comparable business area, namely milk and cheese processing, with similar turnover and market share as well as publicly available data of the Central Statistical Office's reports on the evolution of prices of raw materials (here: milk) in the analysed period.

In order to assess the market nature of the discussed transactions, in addition to the level of prices also the payment periods were verified. Despite the fact that following the common market practice and contractual terms of transaction the payment period was 30 days, the actual payment date by the buyer (related distributor) was three times longer. The court concluded that the extension of payment period without additional remuneration such as default interest on the amounts due would not be possible in normal market practice in the event of non-related entities.

As presented above, tax authorities and courts tend to scrutinize more closely the controlled transactions, in particular if these relate to the main operating activity of the examined entities. In such cases, the examined transactions are assessed over a few subsequent years also in terms of financial results of the other parties involved in order to verify if the formation of prices on a defined level does not serve to minimise the total tax burden (e.g. by disclosing alternately a positive tax result of one entity matched by a tax loss of another entity).

It should be emphasised that if the upward adjustment concerns transactions effected between local entities, there is no possibility to apply the adjustment mechanism by another party to the questioned transaction, and by the same token, an economic double taxation of income occurs.

It is therefore of paramount importance to focus on the method of calculating prices in the local transactions between related entities. We also recommend making sure that both the financial conditions (price, margin) and the conditions of delivery and payment do not raise doubts as to their market nature, i.e. whether they would be acceptable to non-related parties.

A comparable analysis is not a compulsory element of transfer pricing documentation, however, in practice providing such information by the taxpayer can be crucial in the event of tax inspection, as it allows the taxpayer to select possibly the most comparable data (concerning functional profile, scale of transaction and other important circumstances).

Events

We invite you to themed breakfasts and seminars run by Mazars tax experts:

➡ **27 October 2011, 9:30 – 1:30, the office of Mazars in Warsaw, Piękna 18 Street**
Tax Conference - „ VAT: recent issues related to tax on goods and services – along with presentation of amendments made and planned for 2011”

More information and registration: Aneta Sadkowska, Bussines Development, tel. 22 25 55 200

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