

Tax Newsletter

NEWSLETTER Issue # 20 – November 2011

Dear Sirs,

In current issue of our Newsletter you will find a commentary on taxation of private medical insurance (in connection with the resolution of NSA of 24 October 2011, upholding the position of the Minister of Finance and tax authorities on the necessity of paying PIT on private medical insurance policies considered as gratuitous benefits).

Starting from 1 January 2012, amendments to the Double Taxation Avoidance Agreement between Poland and Switzerland will take effect – you will find more details further on.

Moreover, we discuss how to treat guarantees and sureties between related parties and we refer to the ruling of ECJ of 27 October 2011 on the treatment of debt assignment in the scope of VAT.

I hope each of you will find here something of interest.

On this occasion, I would also like to remind you about Mazars Tax Conference on 23 November 2011 (next Wednesday) – Transfer pricing – current issues. We cordially invite you to participate.

Yours sincerely,

Krystyna Szydłowska

EDITORIAL

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PIT: Taxation of private medical insurance

The value of individualized private medical insurance (PMI) provided by employer for employees is subject to Personal Income Tax.

Pursuant to the resolution of 24 October 2011 (ref. no. II FPS 7/10), the Supreme Administrative Court (NSA) maintained its taxpayer-unfriendly stance with respect to taxation of PMI formulated in the resolution of 24 May 2010 (ref. no. II FPS 1/10). By the same token, the resolution eventually confirmed the opinion, expressed several times, both by the Minister of Finance and tax authorities, **that offering a free private medical care to employees is a gratuitous benefit subject to PIT.**

Thus, in the event of financing PMI to employees by the employer, adding its value to the employees' income is necessary. At the same time, the value of PMI is the base for calculating social security contributions, unless it is excluded from this base in accordance with the Regulation of the Minister of Labour and Social Policy of 18 December 1998 on detailed principles of establishing the base for retirement and invalidity pension contributions. It is worth noting that there is no obligation to add the value of PMI covering the occupational medicine services to the employee's income as their provision is compulsory for the employer in compliance with separate regulations.

The employers, who have not included the value of PMI funded to employees in their income until now, should proceed to appropriate adjustments of PIT and social security contributions and pay the resulting arrears with interest. Otherwise, the employers might be burdened with responsibility for non-fulfilment of their obligations in accordance with the Tax Ordinance Act and/or Fiscal Penal Code. It should be added that the non-collection of tax with respect to taxable income earned by the employee does not exempt the latter from the obligation of disclosing it in the tax return. This obligation also applies to employees if the tax was not collected by the withholding agent but the employee was informed about his/her total income earned. If the total income is not disclosed in the tax return, the employee should adjust his/her tax returns for years when he/she did not disclose the income, namely the benefit resulting from PMI.

Considering the periods of prescription specified in the Tax Ordinance Act, PIT adjustments should go back up to 5 years. For social security contributions, the period subject to adjustment should be 10 years, due to the longer period of prescription than for Personal Income Tax.

PMI financed by the employer for his employees represents *other gratuitous benefit*, the value of which, for the purpose of determining the income, should be established according to the purchase price of this service paid by the employer. In the event of giving access to private medical care free of charge, PMI cover itself is considered to be the gratuitous benefit, not the actual use of a given service. Therefore, employers who are charged for PMI paid for each employee will not have much difficulty in determining the value of PMI that have to be added to the income of particular employees. As a rule, they usually have information available enabling them to determine beyond dispute which employee in a given month used PMI and what would be the resulting charge for the employer. A problem with determining the income might occur if the employer providing medical cover to his/her employees was charged globally for this service without getting a breakdown of charges for occupational medicine services and other services. A similar situation would occur if the monthly fee was paid by the employer regardless of the number of employee covered (lump sum).

We would like to draw your attention to the fact that the above-mentioned resolution of NSA of 24 October 2011 does not find a solution to the question of determining employee's income arising from gratuitous benefits, the value of which cannot be attributed to a specific employee, e.g. with respect to income that could arise as a result of employee's participation in an integration event. Hence, the questions below remain relevant:

- How to determine the income of each employee if the employer is charged for services provided to them free of charge in a manner not allowing to attribute beyond dispute the value of benefit to a given employee?
- In this context, is it acceptable to determine the value of such gratuitous benefit using a statistical method (i.e. by dividing the global amount related tot the service by the number of people entitled to use it) also if it results in an uneven attribution of employee's income as compared to the actual value of benefit used by the employee?

International tax law: Amendments to the Double Taxation Avoidance Agreement with Switzerland

The Protocol amending the Polish-Swiss Double Taxation Avoidance Agreement entered into force on 17 October 2011.

This Protocol changes considerably the present Agreement in some areas. As it will become applicable (with some exceptions) on 1 January 2012, getting to know the introduced changes can be useful.

Withholding tax - dividends

When discussing the withholding tax levied on dividends, it is worth mentioning the participation exemption according to which no tax is perceived in the country of residence of the company paying out the dividend if its beneficial owner is:

- A company (other than personal partnership) of another country holding directly at least 10% shares in the company paying out the dividend for the uninterrupted period of 24 months,
- A pension fund (or a similar institution).

At present, instead of exemption there is a possibility of reducing the withholding tax rate to 5%, provided that the company receiving the dividend holds at least 25% shares in the company paying out the dividend. By the same token, the Protocol introduces an exemption from withholding tax for dividends following the example of exemption applicable to EU member states. However, the condition for application of exemption (and this remains unchanged) is to have a relevant certificate of residence as at the date of payment.

Taxation of interest and royalties

Currently the maximum rate of withholding tax on royalties and interest is 10%. Once the amendments are introduced, the rate will be reduced to 5%.

Furthermore, if the royalties or interest are paid out between related companies, there is a possibility to apply a tax exemption. However, it is to be remembered that capital links – in accordance with the Protocol – cover situations when:

- The company paying out royalties or interest holds a direct minimum share of 25 % in the equity of the company receiving these amounts, or
- The company receiving royalties or interest holds a direct minimum share of 25 % in the equity of the company paying out these amounts, or
- A third company based in whichever member state of the European Union or European Economic Area holds a direct minimum share of 25 % both in the equity of the company receiving and paying out royalties or interest.

At present there is no possibility of exempting these amounts from taxation. Therefore, this change will be favourable to taxpayers. However, this exemption will become effective not earlier than 1 July 2013.

Real estate clause

Apart from amendments presented above, a so-called “real estate clause” was inserted in the agreement (art. 13 – capital gains). In compliance with general rules of international law, capital gains are subject to taxation in the country of recipient of these gains. The real estate clause modifies this rule by stipulating that capital gains on disposal of shares in the company, in which real estate accounts for 50% or more of company value, can also be taxable in the country where this real estate is situated.

Having considered the above, it is still possible to do tax planning of transactions between Polish and Swiss companies (e.g. sale of real estate, repayment of loan etc.) to reduce tax burdens.

CIT / Transfer pricing: Intragroup guarantees – market fees will protect you from dispute with tax office

Giving a guarantee to related entities is connected to the obligation of establishing a guarantee fee in compliance with transfer pricing regulations.

In the current economic context, businesses frequently seek sources of finance for their current activity in order to ensure the continued functioning of the entity; however, the limitations imposed on the financial market greatly hinder the collection of additional funds. On several occasions, only guarantees given by related entities (most often parent entities or specialized financial entities) belonging to the same capital group enables the company to obtain credit at beneficial terms. The current position of tax authorities and administrative courts is that the beneficiary of guarantee derives benefits (also in terms of finance) already at the moment of receiving the guarantee (intragroup guarantees are conditions precedent to performance of credit agreement and have an impact on the terms and conditions established by the bank, e.g. with respect to interest rate, commission or credit security).

Until recently, tax authorities in their interpretations have expressed a different view, namely that granting a guarantee does not bring any tax effects until the moment of actual performance of obligations resulting from the guarantee (i.e. the guarantor paying the debt for the debtor). What speaks in favour of such a view is that only then the guarantee is actually made use of.

Nevertheless, recent interpretations and judgments explicitly show that, in the tax authorities' opinion, benefits resulting from guarantee granted by related entities arise at the very moment of issuing such guarantee, and that the guarantor, due to the risk taken, should be remunerated according to market rates. Thus, if guarantees within one capital group are granted free of charge, they should be treated as gratuitous benefits for the guarantee beneficiary and be subject to taxation in accordance with art. 12 section 1 point 2 of the CIT Act. Receiving the guarantee brings tangible and measurable benefits to the beneficiary (among others, increasing his/her credit capacity, lower financing charges thanks to better credit rating) whereas there is no equivalent benefit for the guarantor. The acceptance of risk of repayment of liabilities by the guarantor is a service of a certain value. In other words, it is possible to define the price that the beneficiary of guarantee would have to pay in normal market conditions. This position is supported by administrative courts and tax authorities, among others, in the judgments of NSA of 12 March 2010 (ref. no. II FSK 1776/08) and Regional Administrative Court in Łódź of 4 January 2011 (ref. no. I SA/Łd 1064/10); and individual interpretations of the Fiscal Chamber Director in

Poznan of 18 May 2011 (ref. no. ILPB3/423-68/11-2/GC) and Fiscal Chamber Director in Katowice of 23 February 2011 (ref. no. IBPBI/2/423-1696/10/SD).

In order to reduce the risk of dispute with tax authorities, it is recommended to define remuneration for the guarantor for taking the risk related to the creditworthiness of a debtor. The appropriate fee for guarantee that would be expected by the independent parties making such a transaction should be fixed according to arm's length principles.

Polish regulations as well as legislation of other countries do not include detailed provisions referring to sureties/guarantees and their valuation. In accordance with the Regulation on transfer pricing¹ (§21) the market price for given/received guarantees would be the amount of commission set by non-related entities for the service provided under comparable conditions. Therefore, in order to meet the criterion of market value, the guarantee fee should be fixed at the level reflecting prices applied by non-related entities, including differences in non-price conditions of the transaction. The possible differences should arise from objective, economically justified reasons and not only from links between the parties. If the above-mentioned differences can have a significant impact on the value of transaction, the parties should be able to make reasonably exact adjustments to eliminate these differences.

However, the taxpayer will not always be forced to apply a guarantee fee or recognize the income due to gratuitous benefits. Cases may occur when, considering the cooperation between the parties as a whole, the guarantees are not recognized as separate transactions. In such case the taxpayer should make sure to prepare complex tax documentation (so-called *defence file*), where the economic reasons justifying the non-application of guarantee fees / inclusion of these costs in the price of other transactions are set out. The taxpayer will be able to use such documentation to defend his/her position in case of potential disputes with tax authorities.

Moreover, if the commission for the granted/ received guarantee exceeds the amount of 30,000 EUR in a given fiscal year, the taxpayer benefiting from such service will be obliged to prepare transfer pricing documentation in accordance with Article 9a of the CIT Act.

¹ Regulation of the Minister of Finance of 10 September 2009 on the method and procedure of determination of corporate entities' income by estimation as well as the method and procedure of eliminating double taxation of corporate entities in case of related part profit adjustment (effective since 14 October 2009)

CIT: Benefits for shareholders and members of company bodies

In practice, in the majority of cases, in addition to the basic remuneration for performing functions in the bodies of incorporated companies, their members often obtain perks in the form of benefits or bonuses paid in cash. The same applies to shareholders who, apart from dividends, receive additional benefits or are beneficiaries of perks paid by the company.

When analyzing the method of tax treatment of such expenses, it is good to remember that, first of all, it is the link with earning income or keeping/securing the source of income that decides about the possibility to consider them as tax deductible for the company paying out these benefits.

However, even demonstrating the link with the income earned by the company does not automatically give rise to recognizing them as tax deductible. Each time, they have to be analyzed in terms of so-called “negative catalogue of costs”, i.e. these costs that were explicitly indicated by the legislator as non-tax deductible. In this case, article 16 section 1 point 38 of the CIT Act may apply, according to which expenses related to providing unilateral benefits for shareholders not being company employees are excluded from tax deductible costs.

When analysing this regulation please note that the following conditions decide on the exclusion from tax deductible costs:

- The Company incurs costs related to benefits for shareholders,
- The beneficiaries (shareholders) are not employees of the company,
- Benefits are of unilateral nature.

If a specific expense meets the above criteria, it cannot be considered as tax deductible in accordance with the CIT Act. The first two conditions seem clear, however, the third condition concerning the unilateral nature of benefit is not that obvious anymore. Please remember that unilateral benefit is one for which there is no equivalent mutual benefit in given circumstances. This means that the exclusion from costs will not apply in the case when the shareholder is obliged to provide a corresponding benefit for the company. In particular, remuneration for work carried out for the company is not deemed an unilateral benefit, this view being confirmed by the letter of the Head of Tax Office in Cracow of 19 July 2005 (ref. no. DP3/423-7/05/57131).

Similar regulations were also set out with respect to benefits for the members of company bodies in art. 16 section 1 point 38a of the CIT Act. In line with this regulation, expenses for members of supervisory boards, audit committees and decision-making bodies of corporate entities, except for remuneration paid with respect to performed functions, are not considered as tax deductible costs. A special focus must be given to the fact that the discussed regulation does not impose any specific limitations as to the exclusion from tax deductible costs. However, such limitation is not applicable to remuneration for performed functions, which will always be a tax deductible cost. As a consequence, it has to be examined whether it would not be more tax effective to increase the remuneration for performed functions and drop additional benefits.

VAT: Assignment of a debt without VAT

Debt assignment is not a service and therefore it is not subject to VAT.

The ruling of the Court of Justice of EU of 27 October 2011 (case C-93/10) definitely confirmed the position adopted by certain administrative courts that debt assignment does not fall within the scope of VAT.

ECJ in response to the preliminary reference of the German Court in the case of Bundesfinanzhof against GFKL Financial Services AG ruled that “an operator who, at his own risk, purchases defaulted debts at a price below their face value does not effect a supply of services for consideration and does not carry out an economic activity”. This ruling will be most probably confirmed by the Polish Supreme Administrative Court (NSA) which received a preliminary reference for examination regarding VAT on the acquisition of a debt for the purpose of its collection. By its decision of 8 November 2010 NSA stayed the proceedings on this matter, however, following a European Court of Justice ruling, it will probably reopen the proceedings soon.

Until now, tax authorities were of the opinion that debt assignment for the purpose of its collection should be classified as a service of debt collection subject to VAT (individual interpretation of the Director of Fiscal Chamber in Poznań of 8 August 2011, ref. no. ILPP2/443-764/11-5/EN; individual interpretation of the Director of Fiscal Chamber in Warsaw of 26 April 2011, ref. no. IP1-443-272/10-2/MP). These authorities argued that by acquiring a debt in order to collect it afterwards the assignee (acquirer of debt) provides a service consisting in relieving the assignor (former creditor) from the debt-recovery operations. Such view was also expressed by some administrative courts (NSA in the judgment of 16 February 2010 ref. no. I FSK 2104/08; Regional Administrative Court in Poznań in the judgment of 18 August 2010 ref. no. I SA/ Po 282/10).

Opponents of this concept pointed out that the assignee carrying out the enforcement of the acquired debt or its resale performs this activity for his own sake, hence he does not supply debt collection service for the assignor. Such view was expressed among others, by the Regional Administrative Court in Łódź in the judgment of 10 May 2011 (ref. no. I SA/Łd 351/11).

By confirming that the debt assignment for the purpose of debt collection is not a service, ECJ also stated that VAT would not occur only if the difference between the face value of a debt and its selling price reflects the actual economic value of a debt at the moment of its sale. Please bear in mind that tax offices might attempt to question the economic validity of debt transfer transaction.

Furthermore, debt collection companies should also remember that if the agreement regarding transfer of proprietary rights does not fall within the scope of VAT, the obligation of payment of tax on civil law activities arises. This tax amounts to 1 % of the market value of a debt.

Events

We are pleased to invite you to business breakfasts and seminars conducted by tax experts of Mazars:

- ➡ **23 November 2011, between 9.30 a.m. and 13:30 p.m., Mazars office in Warsaw, ul. Piękna 18**
“Transfer pricing: Current issues, fiscal authorities’ inspections, administrative courts’ practice”

For more information and registration: Aneta Sadkowska, Business Development, phone no. 22 25 55 200, a.sadkowska@mazars.pl

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