

Tax Newsletter

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Dear Sirs,

In the current issue of our Newsletter we discuss major amendments (that may come into force already from 1 January 2013) to the double taxation avoidance agreement with Luxembourg that are particularly important for real estate companies.

Concerning the Protocol amending the convention with Luxembourg signed this month, the most significant amendment is the introduction of the real estate clause. This amendment will mostly affect Luxembourg-based holding companies who own directly or indirectly shares in Polish real estate companies. In the case of sale of shares in such companies, the related profit on sale will be taxable in Poland (before amendment this profit was subject to Luxembourgish tax jurisdiction and was usually exempted from tax). The discussion of planned amendments to this agreement can be read further in this Newsletter. Moreover, we have presented the objectives of the newly signed agreement for the avoidance of double taxation between Poland and Canada.

We also devote some attention to the transfer pricing issues: sureties granted to the companies free of charge by their shareholders and approach of tax authorities and courts to examination of market nature of transactions between related parties.

I encourage you to get familiar with all the tax news that we have selected and prepared for you.

Yours sincerely,

Krystyna Szydłowska

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1 CIT: Significant amendments to the double taxation avoidance agreements

Protocol amending the Convention for double taxation avoidance with Luxembourg

A protocol amending the current tax treaty with Luxembourg was signed on 7 June 2012. According to the new regulations the **principal method of double taxation avoidance is the method of exemption with progression**. However, **tax credit method** shall be applied with respect to Polish residents deriving income in the form of dividends, interest or royalties in Luxembourg.

Another key change is the so-called real estate clause according to which the profit arising from transfer of ownership of shares in a company whose assets are mainly composed of immovable property will be taxable in the country where this property is situated.

Newly signed double taxation avoidance agreement between Poland and Canada

According to the information provided by the Ministry of Finance, a new convention between the Republic of Poland and Canada for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income was signed on 14 May 2012 in Ottawa thus replacing the 1987 convention. **The amendment is to reduce the amount of impositions and thus boost investment flow between Poland and Canada.**

In line with the new Convention, the main method of double taxation avoidance in the case of Poland will be the method of exemption with progression according to which the income derived outside the territory of Poland is exempted from the taxation basis in the country. In order to determine the tax rate on income generated domestically, the tax rate applicable to the total income will apply, i.e. along with the income derived abroad.

However, the tax credit method will be applicable to capital gains resulting from dividends, interest, royalties as well as to profits arising from transfer of ownership of assets; and in this case the whole

income is taxable in Poland; however, there is a possibility of deducting the tax already paid abroad from the tax due in Poland.

In the newly signed Convention the tax rates on capital gains were fixed respectively at 5% and 15% (dividends), 10% (interest), 10% (royalties) thus reducing the maximum rate of withholding tax levied on dividends in intercompany settlements and on repayment of interest. The Convention contains a full clause of exchange of information on tax matters.

Protocol amending the double taxation avoidance agreement between Poland and Iceland

A protocol amending the Agreement between the Government of the Republic of Poland and the Government of the Republic of Iceland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital was signed in May 2012.

In the protocol signed in Reykjavik by Poland (on 16 May 2012) the tax credit method was replaced by **method of exemption with progression**. However, the amendments introduced based on the protocol do not concern capital gains i.e. interest, dividends, royalties and profits from the sale of assets with regard to which the tax credit method is still applicable. The Polish-Icelandic Protocol, just like the Polish-Canadian Convention, provides for the full clause of exchange of information on tax matters.



2 CIT / Transfer pricing: Minister of Finance confirms: Surety granted to the company free of charge by its shareholder constitutes a taxable income

In connection with the existing interpretation discrepancies the Minister of Finance issued a general interpretation on 27 April 2012 (ref. no.:DD5/033/2/DZQ/2012/DD-134) confirming that the use of surety granted free of charge by the company's shareholder is not tax neutral and constitutes a taxable income in the meaning of the Act on Corporate Income Tax¹ (hereinafter: CIT Act).

The taxation of guarantees and sureties granted free of charge has been the subject matter of numerous though inconsistent judgments and decisions of tax authorities and administrative courts. The tax treatment of such transactions is considered usually with respect to ever common sureties and guarantees granted to the companies within capital groups, among others, for bank credits being the widespread method of collecting funds for financing activity on a day-to-day basis and for investments. Due to the fact that the analysis of the current practice in this matter has shown that there is a discrepancy between the position of tax authorities² and voivodship administrative courts³, and the opposed view of the Supreme Administrative Court⁴, the Minister of Finance, following the amended Tax Ordinance⁵ gave a general interpretation to ensure a consistent application of tax law.

In his interpretation the Minister of Finance states that **the fact of granting a surety causes the**

guarantor to assume the financial risk of default of the debtor in its obligation to the creditor. This risk has a determined value i.e. the price that the party obtaining the surety would have to pay to the guarantor under normal market conditions. The financial advantage of the party obtaining the surety may consist in e.g. increasing their credit score, obtaining a lower loan interest or the possibility of getting the credit in itself. On the other hand, the fact of granting a surety has an impact on the possibility and terms and conditions of contracting other financial obligations by the guarantor. In this context, from the point of view of the party obtaining the surety there is a material benefit non connected with costs or other form of equivalent that has a real financial dimension and therefore meets the criteria for considering the fact of granting the surety free of charge to be a gratuitous benefit under the CIT Act and gives rise to taxable income for the party obtaining the surety.

Despite the taxpayer-friendly decisions of the tax authorities and voivodship administrative courts stating that the taxable income of the beneficiary of free-of-charge guarantees only arises upon the execution of the surety (e.g. repayment of the credit for which the guarantor stands as surety), and thus deriving material benefits at the expense of the guarantor; in line with the position of the Minister of Finance, the qualification of such transactions effected between related parties to be non-gratuitous benefits and non-recognition of related income seems to be risky.

According to the opinion expressed also by the Supreme Court of Justice, **the fact of granting a surety under normal market conditions is a paid service and therefore the saved fee that the company would have to pay for such financial service should be deemed an income subject to taxation.**

While explaining the question of free-of-charge sureties the Minister of Finance also stated that in order to determine the value of surety granted to the company by the shareholder free of charge one should make reference to: prices applied by the guarantor to other entities (if such services are included in the scope of business activity of the shareholder) or to market prices of the discussed benefits taking into account the time and place that they were provided⁶.

¹ In accordance with article 12 section 1 point 2 of the Act on Corporate Income Tax of 15 February 1992 (Journal of Laws of 2000 no. 54 item 654 as amended).

² Interpretation of the Fiscal Chamber in Katowice of 1 March 2010 (IBPBI/2/423-1489/09/PC)

³ Judgment of the Voivodship Administrative Court in Gliwice of 20 May 2008 (I SA/GI 35/08), judgment of Voivodship Administrative Court in Łódź of 4 April 2008 (I SA/Łd 57/08), judgment of Voivodship Administrative Court in Gliwice of 19 June 2008 (I SA/GI 248/08).

⁴ Judgment of the Supreme Administrative Court of 8 December 2009 (II FSK 1156/08), Judgment of the Supreme Administrative Court of 26 January 2010 (II FSK 1417/08), Judgment of the Supreme Administrative Court of 12 March 2010 (II FSK 1776/08).

⁵ Act of 29 August 1997 Tax Ordinance (Journal of Laws of 2005 No. 8, item 60 as amended)

⁶ In accordance with article 12 section 6 item 1 or article 12 section 6 item 4 of the CIT Act respectively.



3 Transfer pricing: Practical approach of tax authorities and administrative courts to the auditing of market nature of settlements between related entities

In the light of judgment of the Supreme Court of Justice of 27 March 2012 (ref. no.: II FSK 1882/10) dismissing a cassation of a taxpayer, it has become clear that tax authorities more and more thoroughly examine transactions carried out by the controlled entities with related contractors using the growing experience and practical knowledge in the field of methodology of analysis and determination of market level of settlements.

The case concerned a taxpayer (smithy) running a business in the area of manufacture of wrought products who purchased the main raw material (forging steel) during the audited period in approx. 75% from a related party (majority shareholder) fulfilling the role of intermediary in the transaction. The performance of the above transactions was based on the agreements for the purchase of steel concluded by the parties and for purchase of services of coordination of purchase of materials, raw materials, tools and equipment. The remaining part of raw materials for further processing was purchased by the Taxpayer directly from the manufacturer (steelworks).

Following the inspection on the subject matter the Director of the Tax Control Office gave a decision determining the CIT liability for 2006 in the amount higher than the one declared in the tax return. The reason for giving the decision was irregularity concerning the application of prices in transactions with related party (fulfilling the role of intermediary in the purchase of forging steel from steelworks). The first instance authority found that as a result of existing relationships between the Taxpayer and the intermediary the prices were fixed while not obeying the arm's length principles which gave rise to overestimation of tax deductible costs by the Taxpayer (by nearly PLN 1.4 million), and therefore to underestimation of taxation basis.

The decision challenged by the Taxpayer (confirmed by the second instance authority and voivodship administrative court) was based on the detailed controllers' analysis of terms and conditions of transactions between related parties.

The analysis of collected evidence and information showed that the Taxpayer purchased the same type of steel in the same period at a price nearly 20% lower directly from a non-related supplier (manufacturer). It was also determined that the prices at which the related intermediary sold steel to the Taxpayer (smithy) were the highest on the pricelist or even exceeded the level set on the pricelist. On the basis of the internal comparison of prices applied in transactions with independent parties the tax authorities concluded that it was more reasonable for the taxpayer to purchase forging steel directly from manufacturers (steelworks).

Subsequently, the tax authority also made an external comparison of prices applied in transactions between non-related parties. To this end, it asked independent entities with similar profile (smithies) and size and steel manufacturers (steelworks) to provide the relevant data – comparable data (*secret comparables*). The information provided led to a conclusion that all the smithies purchased steel directly from manufacturers (without intermediaries) and the purchase prices of steel paid by the Taxpayer were (with few exceptions) higher than the prices paid by the same type of smithies subject to comparison. The analysis of selling prices applied by steelworks showed that they were at a similar level with regard to different clients, both smithies and related intermediary.

Apart from direct comparison of prices and other significant terms and conditions of transactions applied by non-related parties, the authority also compared financial results of the Taxpayer with the results of entities with similar profile. The analysis of data contained in the financial statements published in Monitor Polski (publicly available data) showed that the Taxpayer was the only one to incur a loss on sales in 2006 and recorded the lowest net result. All the analysed profitability ratios (operating return, return on sales) of the Taxpayer were at a definitively lower level than in other smithies.

In the light of collected evidence, the authority found that the prerequisites specified in article 11 section 1 in conjunction with article 11 section 4 item 1 and section 5a of the CIT Act were fulfilled and hence estimated the income in line with article 11 section 2 of this Act.

For the purpose of estimation, the authority applied the tax method indicated by the taxpayer in transfer pricing documentation prepared for the



analysed transaction i.e. cost plus method. In addition, the possibility of application of each method provided for in the legislation was analysed and the reasons for which the uncontrolled price method and resale minus method were considered to be unsuitable in this case and the choice of relevant method, i.e. cost plus method was thoroughly justified. The authority adopted the margins (other ratios) applied by the sample group selected for comparison, i.e. intermediaries selling general purpose steel, as reference to assess the market nature of margin set by the parties. According to the authority, although physical and chemical differences between the general purpose steel and forging steel have a significant impact on their prices, they do not affect the margin expressed as percentage which should ensure the payment of costs and generate the profit corresponding to market conditions. **In the authority's opinion, the cost plus method allows eliminating differences in compared goods and achieving the comparability of entities by means of functional analysis and application of the scoring method enabling to assess the fulfilled functions, assumed risks or involved assets.**

When dismissing the cassation, the Supreme Administrative Court confirmed the validity of methodology applied by the tax authorities and recognized by the Voivodship Administrative Court.

It is important from the point of view of taxpayers that the authorities examining the market nature of controlled transactions are more and more familiar with transfer pricing issues and use more and more detailed data for comparison, including information obtained specifically for that purpose from other economic operators (considered to be comparable by these authorities) (so-called *secret comparables*). The judgment of the Supreme Administrative Court presented in this article should be a valuable indication for taxpayers carrying out transactions with related parties within their core operating activity that will enable them to analyse on their own and assess the potential risk in the area of transfer pricing (potential estimation of income) for the company.

4 PIT: taxation of profits earned by the shareholders of partnerships limited by shares

Another important judgment of the Supreme Administrative Court was rendered on 26 April 2012 with regard to taxation of profits earned by shareholders of partnerships limited by shares (SKA) and the Minister of Finance gave a general interpretation in this matter on 11 May 2012.

As we already mentioned in March issue of tax Newsletter, the taxation of dividend paid to the shareholder of SKA was the subject matter of the resolution of 7 judges of the Supreme Administrative Court passed in January (resolution of 16 January 2012, ref. no. II FPS 1/11). In this resolution the Supreme Administrative Court stated that the income of SKA shareholder not being a general partner obtained as dividend paid pursuant to the resolution of the General Shareholders' Meeting on profit distribution is subject to taxation on the date of actual receipt of dividend.

However, the resolution did not solve definitively the question of classification of shareholder's income, particularly in the light of PIT Act. Therefore the shareholders were not sure whether the dividend paid from the profit of SKA should be treated as income from business activity or as capital gains. Eventually this doubt was dispelled following the general interpretation of the Minister of Finance of 11 May 2012 (ref. no. DD5/033/1/12/KSM/DD-125), **in which the Minister of Finance considered that the amount of dividend granted to the shareholder (individual or company) by the General Meeting of SKA pursuant to the resolution on profit distribution constitutes an income from business activity**, on which an advance on income tax must be paid for the month in which it was earned. Moreover, in line with the interpretation, if the taxpayer also gets other income from business activity apart from the above income, the dividend will increase the amount of advance due on income tax for the month in which the resolution on dividend payment to SKA shareholders was adopted (or in which the "dividend date" was defined). The classification of shareholder's income as business income was also confirmed by the judgment of the Supreme Administrative Court of 26 April 2012 (ref. no. II FSK 1070/10).



The above-specified judgments and general interpretation of the Minister of Finance can contribute to increasing the “attractiveness” of the partnership limited by shares and making this form of business more popular. **The main advantage of running business in the form of SKA is the possibility of re-investing the profit attributable to a shareholder without the obligation of paying tax on this profit – as long as profits attributable to SKA shareholders are reinvested** (as long as dividends from these profits are not paid out), there will be no need to pay related income tax.

In addition, in their recent statements, the representatives of the Ministry of Finance do confirm that since the dividend for shareholder is calculated taking into account all operating costs

in line with the Accounting Act (all limitations concerning tax deductible costs resulting from the PIT Act do not matter) such amount of dividend should be applied as taxation basis for calculating tax by this shareholder (partner). The above means that SKA shareholders with comparable level of income and expenses may pay lower tax than partners in civil law partnership or general partnership or limited partners of the partnership. However, it is difficult to predict whether the above position of the Minister of Finance regarding the taxation basis will be maintained or not.

Running business in the form of limited partnership by shares is undoubtedly attractive based on the current regulations; however, one has to remember that the legislator can change these SKA favourable regulations in the future.

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