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Implementation of the EU tax directives in Poland

Since Poland joined the EU on May 1 2004, Polish tax law need to be adapted to the EU Council directives for the member states. The new legal environment obliged Polish authorities to implement the EC Council parent-subsidiary directive (Directive 90/435/EEC, hereinafter "PSD"), the EC merger directive (Directive 90/434/EEC, hereinafter "MD") and two recent directives: one concerning the common system of taxation applicable to interest and royalty payments made between associated companies of different member states (Directive 2003/49/EC, hereinafter "IRD") as well as another on the taxation of savings income in the form of interest payments (Directive 2003/48/EC, hereinafter "SD").

Up to now neither the Parent-Subsidiary Directive nor the Interest and Royalty Directive has been fully implemented into the Polish Corporate Income Tax (CIT) Law. This paper examines the most substantial issues included in the amended CIT Law, which seem to be not always compatible with the EU directives.

Implementation of the PSD

Polish transposition of the changes made at the EU level to the Parent-Subsidiary Directive has been accomplished primarily by amending Art. 20 and 22 of the CIT Law. The PSD provides that dividends which a subsidiary distributes to its parent company are exempt from the withholding tax if the parent company holds a minimum of at least 20% of the share capital[1] of the subsidiary. However, pursuant to the PSD, member states can either:

a) replace, by means of a bilateral agreement, the criteria of a holding in the capital by that of a holding of voting rights or

b) not apply the PSD to companies of that member state which do not maintain, for an uninterrrupted period of at least two years, a holding qualifying them as parent companies or those of their companies in which a company of another member state does not maintain such a holding for an uninterrupted period of at least two years.

Therefore, according to the amended Polish CIT Law, which incorporates Art. 5 of the PSD, income from dividends and income from capital gains is tax-exempt provided that it is generated by companies which cumulatively fulfill following conditions :

a) their seat of management is outside Poland

[1] Down from 25% in 2004, the minimal holding requirement will gradually decrease to 15% from January 1, 2007, and to 10% from January 1 2009.

b) they are subject to corporate tax in another EU member state on the total income generated by such company, regardless of where the income is generated, and

c) the income from dividends relates to a Polish subsidiary, in which such company directly holds at least 25% of the shares in the capital for an uninterrupted period of at least two years.

Unlike most other new EU countries, Poland has implemented the EU Parent-Subsidiary Directive for income dividends by means of tax credit method, under which the dividends paid out by a subsidiary being taxed in the country where the parent company is headquartered, while the tax paid by the parent company is reduced by the amount equivalent to the amount of tax paid on the dividends by the subsidiary. This method is also applied in double taxation avoidance treaties. Furthermore, a reduction of the tax paid by the parent company occurs - in accordance with Art. 4 of the PSD - only up to the amount of the corresponding domestic tax. If the tax credit corresponding to the amount of tax paid on the dividends by the subsidiary is higher than the tax due by the parent company, then the unused part is forfeited. In order to enjoy the above exemption method, the parent company is obliged to possess a certificate of tax residency in the EU member state, where it is headquartered issued by the competent tax authorities of this state. The tax paid by the subsidiary has to be recalculated using the National Bank of Poland average foreign exchange rate on the day of payment.

Polish CIT Law currently does not state clearly enough whether in order to qualify for withholding tax exemption under Art. 4 of the PSD, the shares have to be held for at least two years prior to a dividend payment, or whether the holding period condition may be met at any time after the dividend payment. The new version of Art. 20 of the CIT Law (which is perceived as a reaction to the ECJ decisions in *Denkavit* cases (C-283/94, C-291/94, C-292/94)) continues to exempt from withholding tax dividends paid to an EU shareholder that holds at least 20% of the shares for a period of 24 consecutive months whereby this requirement may also be satisfied after the dividend payment.

The Permanent establishment

The amended Art.20 of the CIT Law which came into force on January 1, 2005, introduces a definition of a foreign establishment. Pursuant to the CIT Law a foreign establishment means

a) a permanent place of business through which the subject whose seat or management office within the territory of one state pursues its activities, in whole or in part, within the territory of another state and, in particular, the place of management, branch, office, factory, workshop or place of extraction of natural resources;

b) a construction site or construction, assembly or installation works carried on within the territory of one state by a subject whose seat or management office is on the territory of another state;

c) a person who, on behalf and for the benefit of a subject whose seat or management office is on the territory of one state, operates on the territory of another state if such person holds and exercises a power of attorney to enter into agreements on its behalf,

provided that the entity, whose seat or management office is on the territory of a foreign state, is subject to tax on income in the state in which it is located.

The abovementioned definition of “a permanent establishment” is based on the OECD Model Tax Convention on income on capital and corresponds with the definition included in Art. 2 section 2 of the MD. The legal definition of establishment from the Polish CIT Law is not exactly applicable to all cases. The hierarchy of legal binding acts stipulates that all international treaties have priority over domestic law. Therefore, the definition of “establishment” found in a relevant double taxation treaty concluded with an EU member state will have priority over legal definition of ‘establishment” in the Polish CIT Law. The notion of establishment included in the CIT Law refers to situations in which there is no possibility of applying the definition from a relevant double taxation treaty.

Implementation of the IRD

Interest and royalties should be in matter of fact free from withholding tax based on the IRD. However Poland has obtained transitional period to apply the Directive.

The reduction of the withholding tax will be made in 3 steps:

1. From July 1, 2005 until June 30, 2009 Poland may levy a 10% withholding tax on interest and royalty payments to qualifying EU residents.

2. After July 1, 2009 until June 30, 2013 Poland may impose withholding tax on such payments at a rate not higher than 5%.

3. From July 1, 2013 no withholding tax will apply to such payments.

As a consequence, for the next eight years, the full exemption from withholding tax on interest and royalties being paid from Poland to other EU member states will not be available.
The above reduced withholding tax rate (the regular withholding tax on interest paid to non-residents is 20% provided no relevant double taxation treaty is applicable) is imposed if a Polish payer **directly** holds a 25% of shares in the capital in an EU recipient or vice versa or another company has driectly at least a 25% shareholding in the payer’s and recipient’s capital for an uninterrupted period of 2 years. This exemption also shall apply if the two- year period of continuous shareholding terminates after the day of the payment. However, if the above condition is not met, the payer of interest is obliged to pay tax including that default interest on this income in the amount of 20% of the withholding tax according to the CIT Law or the relevant double taxation treaty executed by Poland.

The 2005 changes of the CIT Law extend the tax credit benefits for Polish companies. Thus a Polish company will be entitled to CIT deduction of tax paid in other EU member states in a multitiered structure, i.e. tax paid by indirect subsidiaries locally in another EU member state can be deducted from Polish CIT payable by the parent company (dividends received from abroad constitute taxable income for Polish entities).

Implementation of the MD

The Merger Directive applies to mergers and transfers of a business or a part of a business (not individual assets). Provisions of the Polish Corporate Income Tax Law implementing the Merger Directive became partly effective as of January 1, 2003 and partly as of January 1, 2004.

Preferential tax treatment applies exclusively to mergers and divisions and transfer of shares relating to companies having their seat or management in Poland and/or companies having their seat or management on the territory of the European Union.

The fiscal consequences of the first two abovementioned transactions are irrelevant to the Polish market because Polish Corporations Code does not include a legal possibility of cross-border mergers or divisions of companies. However, the transaction of transfer of shares has been incorporated in the amended CIT Law. It is similar to a contribution in kind, but consists as a matter of principle in exchange of shares in the way that the selling company receives the shares of the acquiring company and possibly a cash payment in amount not exceeding 10% of the nominal value of the received shares.

The MD introduces a common system for tax exemption of capital gains connected with mergers and divisions of companies. The fundamental assumption of this system is that those events do not cause any fiscal consequences for either the partaking companies or their shareholders. This mostly applies to the taxation of so-called hidden reserves (stille Reserven) meaning the capital gain arising over the balance sheet value of the shares to be transferred. The Polish CIT Law does not tax silent reserves until the shares they are connected with are sold.

The first amendment of the CIT Law concerning the scope regulated by the MD came into force in 2001. It introduced certain rules in regard to two issues:

- Postponement of taxing the contribution in kind, if the subject of the contribution is an enterprise or its organized part at the day of taking possession of the shares (*a contratrio* to Art. 12 sec. 12 CIT Law).

- Merger of companies – exemption from taxing the silent reserves received by the shareholders of the acquired company (Art.10 sec. 2 CIT Law)

The exemption of silent reserves takes place if and only if the acquiring company has at least a 25% shareholding in the capital of acquired company in regard to voting rights. It follows from Art. 7 of the MD. However, the MD speaks of “share at capital” instead of “share of capital transferable to voting rights”. The exemption of capital gains cannot apply to transaction principally aimed to avoid or evase taxation. It corresponds with Art. 11 of the MD.

The new regulations state that taxable income generated by such transactions refers only to eventual cash payments in amount not exceeding 10% nominal value of received shares, which can be made in favor of seller of the shares (Art.10 sec.1 CIT Law).

Another issue, which has been implemented into the Polish CIT Law is a possibility of taking over the loss suffered by the foreign establishment of an acquired company in case of merger, division and contribution in kind. This is allowed only if the loss had not created a revenue generating cost in the country, where the foreign establishment is situated. A strict interpretation of Art. 20 sec.1 of the CIT Law does not permit to take over the loss of foreign establishment by a company headquartered in another member state. This rule has been implemented only in regard to mergers and divisions (Art. 10 sec.4 CIT Law). Unfortunately, it had been overlooked as far as exchange of shares and contribution in kind are concerned.