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Briefing note

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Thin capitalisation and CFC taxation in Poland – guideline to new CIT rules

Recent changes in thin capitalisation and controlled foreign company ("**CFC**") taxation are among the most important tax issues which will influence the structure and financing of capital groups operating in Poland. This briefing gives a summary of the changes which came into force on 1 January 2015.

The thin capitalisation rules in the Polish CIT Act set out restrictions on the maximum amount of intra-group debt the interest on which a company can treat as tax deductable. When the debt-to-equity ratio exceeds the permitted threshold, interest on such excess paid by the borrower to a creditor in its group cannot be classified as a tax-deductible expense (so it does not decrease its tax base).

Another amendment that may have important implications for Polish capital groups is the new CFC taxation package (commonly referred to as the "act on tax havens"). The objective is to tax "controlled foreign companies" of Polish tax payers so as to prevent them from shifting profits to other jurisdictions with lower tax rates. Choosing a low taxation regime may now, in certain situations (i.e. when there is no tax treaty between Poland and the other relevant country), result in an obligation to compensate for the difference in tax due between that chosen jurisdiction and in Poland.

Key issues

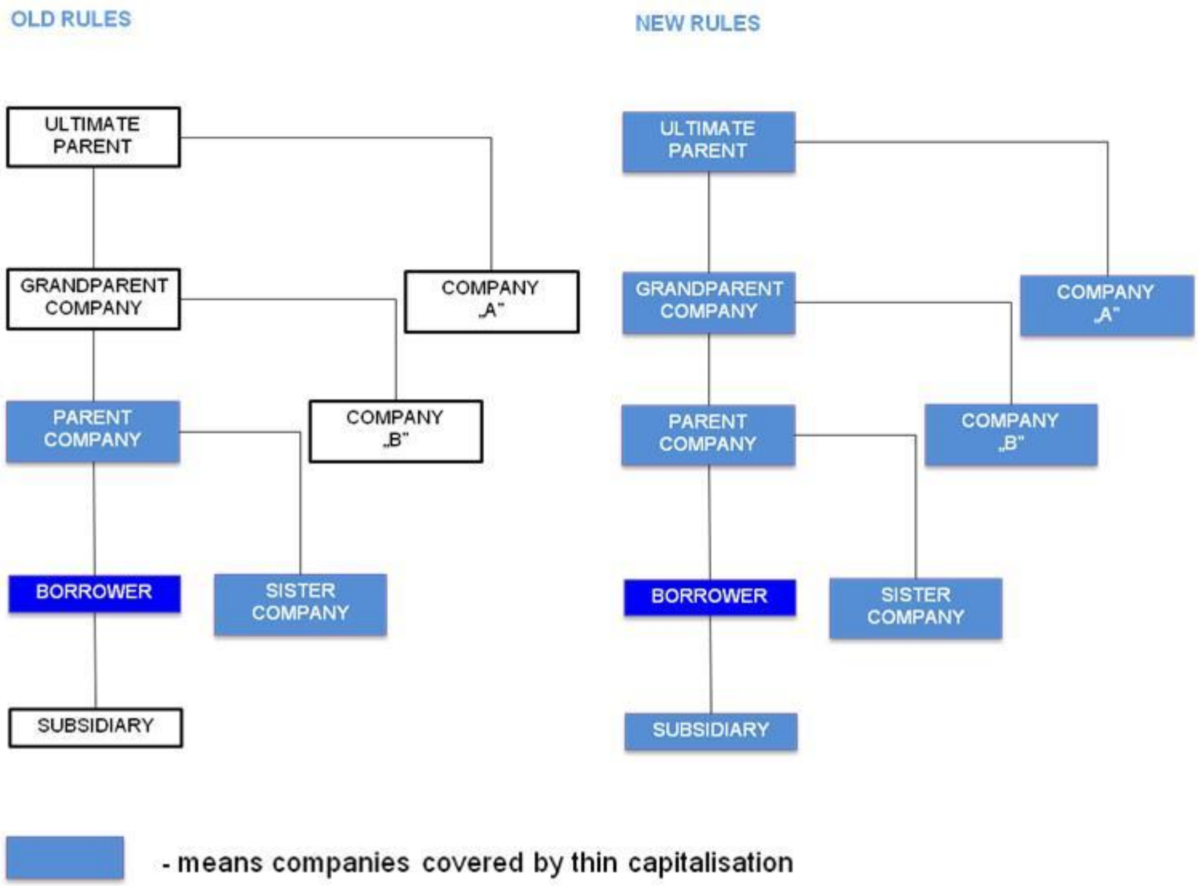
- New thin capitalisation rules
- Alternative model for interest deductibility
- New CFC taxation rules
- Applicability and outcome

New thin capitalisation rules

The list of entities covered by the thin capitalisation rules has been expanded to include partnerships limited by shares (Polish: *spółka komandytowo-akcyjna*) which as a result of other amendments to the Polish CIT Act have now become CIT taxpayers. Previously, they were treated as tax-transparent.

The "affiliate" definition is also expanded:

- Previously only loans from a direct parent or a subsidiary of a direct parent were subject to thin capitalisation rules.
- New rules now also apply when a loan is granted by an indirect affiliate (comprising indirect parent companies and any subsidiaries of such indirect parents and any subsidiary of the borrower).
- The 25 per cent threshold of votes determining whether one entity is an affiliate of another remains unchanged. When a loan is granted by more than one entity, the percentage of votes is cumulative, so the relevant entity can be classified as an affiliate of any of the lenders if the accumulated percentage of votes exceeds 25 per cent.



The definition of "loan" also now includes a credit facility (in addition to a loan, debt securities, irregular deposits or savings accounts, as was previously the case).

A different procedure for calculating indebtedness and determining the debt-to-equity ratio to which the rules apply is introduced:

- The value of indebtedness and capital should be calculated as at the last day of the month preceding the month when the interest is paid.
- The value of indebtedness should, when applicable, be decreased by the value of any loans granted by the borrower to its affiliate companies, so each time the value of indebtedness will be calculated on the basis of funds actually borrowed by a company, without including funds lent to its affiliates.

A different procedure for calculating a company's equity base is introduced:

- Previously, the debt-to-equity ratio was calculated by only taking into account the value of the company's registered share capital.
- Under the new rules, the equity base for determining the debt-to-equity ratio is calculated by taking into account the value of the company's entire equity, with the few exceptions listed below.
- The definition of "equity" does not cover any part of equity that:
  - in practice was not paid up;
  - is derived from the conversion of shareholder loans into equity;
  - is paid up by intangible assets which cannot be depreciated or written off;
  - comes from a revaluation of assets; or
  - is derived from subordinated loans.
- The debt-to-equity ratio has been changed from 3:1 to 1:1.

A slightly different procedure for determining non-tax deductible interest is introduced. The amount of interest which is not tax deductible is the proportion of debt towards affiliated companies exceeding a company's equity to the total debt towards these companies.

Alternative model for interest deductibility

- Instead of the thin capitalisation regime, a company may now choose an alternative model, which applies to interest paid on all indebtedness (including to non-affiliated parties).
- Such interest may not exceed the product of the reference rate of the National Bank of Poland (now 2%) plus 1.25% of the tax value of the company's assets (excluding intangible assets) with the meaning of the Polish Accounting Act (i.e. their depreciated value for tax purposes) as of the last day of the tax year, otherwise it will not be tax-deductible.
- The amount of tax-deductible interest may not exceed 50% of operating profit. This does not apply, however, to banks, credit institutions and financial institutions whose revenue generated in the tax year in question from leasing transactions constitutes 80% or more of its revenue for that tax year or its revenue from purchase and sale of receivables constitutes 90% or more of its revenue for that tax year.
- This method must be notified to the tax authorities within the first month of the tax year it is used and has to be used by the borrower for a minimum period of three years.

New CFC taxation rules

In principle the term "CFC" applies to the following entities: foreign companies and other legal persons, foreign non-transparent partnerships, as well as some other types of foreign undertakings, which belong to one of the categories listed below:

- Any entity registered (or having its management) in 'unfair tax competition' countries, as listed in a separate Polish regulation.
- Any entity registered (or having the location of its management) in countries that have no ratified tax treaties (a double-taxation treaty or a tax information exchange treaty) with Poland or the EU. In this case the obligation to pay additional tax does not apply if the taxpayer proves that at least one of the specific conditions listed below does not apply to the CFC.
- Any entity which meets all of the three conditions listed below:
  - The Polish taxpayer holds, whether directly or indirectly, 25 per cent or more of the shares in the CFC, votes from that entity or right to income from that entity for a minimum period of 30 days (a "Polish holding entity");
  - At least 50% of revenue is passive income (e.g. dividends, any rights to income, statutory or contractual, sale of shares or receivables, interest, loans, guarantees, copyright, industrial property rights, any financial instruments); and
  - At least one of the sources of income mentioned above is subject to either a tax rate equal to or lower than 14.25 per cent or is exempt or excluded from tax, if this is not granted on the basis of Directive 2011/96/EC dated 30 November 2011.

Any Polish holding entity of a CFC is subject to additional tax as follows:

- The additional tax rate is 19 percent. The tax base is determined in accordance with the relevant Polish tax regulations.
- The tax is paid on the income sourced from a CFC in principle in proportion to its shareholding and the period in which the shares are held in the relevant tax year. In the case of CFCs located in 'unfair tax competition' countries its entire income can be taxed at the level of the Polish holding entity.
- Some deductions from CFC sourced income apply.

Exemptions apply to the following types of CFCs:

- CFCs which are subject to taxation on all of their income in the EEA region, on condition that they conduct genuine business activity.
- CFCs with yearly revenue below EUR 250,000 (or its equivalent in other currencies).
- CFCs registered outside the EEA region, on condition that they conduct genuine business activity and their income does not exceed 10 per cent of the revenue of any Polish holding entity of a CFC. In this case, the additional tax is not payable but the information and reporting obligations still apply.

Polish holding entities of CFCs are now subject to certain additional reporting and information requirements. They are obliged, among other things, to:

- Maintain a register of their CFCs.
- Maintain separate tax records for each CFC, to enable its revenue, tax base and tax due to be determined as well as records of each CFC's fixed assets and intangible assets so that the value of depreciation write-offs can be determined.

- File by the end of the 9th month of every tax year a specific tax return, giving the amount of income derived from CFCs in respect of the previous tax year, and pay any additional tax due on this CFC sourced income.

CFCs can be classified as performing genuine business activity in particular (but not only) when:

- Registration of a CFC is connected with the existence of an enterprise (defined by Polish law as "an organized set of tangible and intangible assets intended to carry out business activity"), under which the company carries out activities which are, in fact, business activity, in particular, the CFC has local, qualified staff and equipment used in its business activities.
- A CFC does not create a structure which operates in isolation from business reasons.
- The actual premises of a CFC as well as its personnel and equipment correspond to the scope of the business activity of the CFC.
- Agreements entered into by the CFC are consistent with economic reality, are economically justified and are not obviously contrary to the general economic interests of that company.
- the CFC independently performs its basic economic functions using its own resources, including through existing on-site management.

Non-compliance with any of these conditions means that the CFC can be deemed as not performing genuine business activity.

Applicability and outcome

The new regulations apply from 1 January 2015. However, the new thin capitalisation rules do not apply to loans disbursed before 1 January 2015 (i.e. where funds were transferred to the borrower on or before 31 December 2014).

Thin capitalisation:

- The best solution to be adopted has to be determined on a case by case basis.
- Both compliance with the standard rules and the alternative model have their advantages and disadvantages, and a decision as to the model which is most suitable for a particular tax payer will depend on the characteristics of the company concerned.
- Companies with relatively high equity (and not just share capital) may benefit from the new regulations, as will companies with assets with a high tax value (e.g. banks and financial institutions) and operating profit, as the "alternative model" should enable them to establish a higher basis for tax deductibility of intra group interest.

CFC taxation:

- CFC rules may prove problematic particularly for large capital groups operating worldwide. The numerous resulting obligations and requirements, including those of an information or reporting nature, could be particularly onerous.
- Determining whether a foreign entity in a group performs genuine business activity or falls under the CFC additional taxation regime will require a case by case assessment.

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