Tax law implications for the eastern EU enlargement - The harmonisation of Polish tax law with that of the European Union

***Topic 6:* The accession of ten new EU member states as of 1 May 2004 means that the EU Treaty's freedom of movement provisions will from that date on also apply to these countries.**

Daniel Deak (Budapest)

1. Introduction

To a large extent Polish law has been adjusted to the requirements demanded by European Union law. However, a significant portion of the changes is at this moment to be found in the legislative phase in Parliament or even in the draft phase.

Below can be found a discussion both of the changes already adopted and those being drafted as regards income taxes and capital taxes (the tax on civil law transactions), which are analysed in the light of EU law and the verdicts of the European Court of Justice.

2. Personal income tax

Amendments to the Personal Income Tax Act[1] of 26 July 1991 mainly concern:
- the liquidation of most exemptions and reliefs;

- the establishment of a uniform 19% fixed rate of tax on income received from interest and other income obtained from funds accumulated on the taxpayer's account from other forms of savings (previously this was 20%), dividends and revenues from participation in the profits of legal entities (previously 15%), interest on loans, interest and discounts on securities and income from shares in capital funds (previously 20%);

- the establishment of a uniform 19% tax rate on the sale of securities or derivatives and the realisation of the rights under them; the sale of shares in companies having legal personality; the subscription of shares in companies having legal personality or contributions to cooperatives in return for a benefit in kind other than in the form of the business or a division of it;

- the taxation at the rate of 19% (at the taxpayers discretion) of income from business. If the taxpayer does not choose that method of taxation he is subject to taxation on general principles – at the progressive rates of 19 – 30 – 40% - in that, in this case, as opposed to in the case of the fixed rate, the taxpayer is entitled to a tax-free amount, joint taxation with their spouse and to benefit from tax reliefs.

The above amendments do not breach the free movement of goods, persons and capital under the Treaty Establishing the European Community. In principle, the provisions hitherto do not breach the above freedom of movement either and comply with art. 92 of the Treaty.

The Personal Income Tax Act contains provisions which differentiate between residents and non-residents, although they are not numerous. Differentiation between these two groups of taxpayers does not, in itself, breach the provisions of the Treaty[2]. However, in certain situations such a breach could take place – if in a given country the non-resident generates all or the majority of his income, his legal situation is, in fact, the same as that of a resident[3]. Among the Polish rules which could, *a casu ad casum*, be affected by the above principle and which, as a result, could be deemed as non-compliant with the Treaty, are the following:

- art. 6 para. 2 which reserves the right to the joint taxation of spouses solely for residents,

- art. 24b para. 2 which introduces indexes of income in relation to revenues – specified in the Act – in the event that it is not possible to establish the income on the basis of the accounts which a non-resident taxpayer is obliged to keep. In the case of a resident taxpayer the income is established by way of an estimate, without applying indexes;

[1] Journal of Laws of 2000, No14, item 176 as amended; last amendment: Journal of Laws of 2003, No 202, item. 1956.
[2] Finanzamt Köln-Altstadt v Roland Schumacker. Case C-279/93. *European Court reports 1995 p. I-225*
[3] ibid

- art. 26b which gives only residents the right to offset the costs of the repayment of housing loans against income;

- art. 27d, which allows only residents to deduct donations to organisations for the public good from tax up to the equivalent of 1% of the tax payable;

- art. 29, which establishes a mandatory fixed-rate tax for certain types of income generated by non-residents (e.g. income from activities conducted personally, from interest, copyright, licence fees, artistic activities, from the provision of the following services: advisory, accounting, market research, legal, advertising, management and control, data processing, recruitment, guarantees and pledges, and similar services). The above rules are, however, applied taking into account the double taxation agreements to which Poland is a party.

- art. 45 para. 7, which imposes on non-residents the obligation to file a tax declaration prior to leaving Poland, if that departure takes place before the statutory date for filing such declarations.

Currently the Government is preparing the draft of a law which would amend, inter alia, the Personal Income Tax Act in order to transpose Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments[4]. The basic aim of the directive is to make it possible for interest on savings paid in one member country to individuals who are residents of another country, to be effectively taxed in accordance with the rules in the other country. Pursuant to the declaration contained in the preamble to the Directive, its basic aim can be achieved through an exchange of information regarding the payment of interest between the member countries. Ideally, all the member countries should abandon taxing interest paid to residents of another country at source. The Directive will come into force on 1 January 2005, on condition, however that, inter alia, Switzerland, Lichtenstein, San Marino, Monaco and Andorra introduce measures equivalent to those specified in the Directive by that day.

The draft of the amendment to the Polish Act includes, in arts. 42c and 42d, definitions of the paying entity, the actual recipient, the intermediary recipient and provides for the annual provision of individual information concerning the interest income of a person resident in a member state other than Poland, as well as those non-member states specified above. The draft also regulates the procedure for the establishment of data by the entities compiling the individual information and its content. As regards the tax deducted at source, during the transition period, by Austria, Belgium, Luxembourg, Andorra, Liechtenstein, Monaco, San Marino and Switzerland, as well as the British and Dutch dependent and associated territories, the Polish legislators have applied the method of credits as a way of avoiding double taxation. The version of the draft being prepared by the Government complies with the provisions of the Directive.

3. Corporate income tax

The main amendments to the Corporate Income Tax Act[5] of 15 February 1992 which came into force on 1 January 2004 are:

- a reduction in corporate tax from 27% to 19%,

- an increase, from 15% to 19%, in the fixed-rate tax on dividends from shares in the profits of legal entities,

- the amendment to arts. 20 and 22 which adjusts the Polish rules to the principles of the Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC)[6] – this amendment will be discussed later,

- relaxing the conditions for the creation of a capital group – mainly through a reduction in the profitability requirement from 6% to 3%,

- postponement of the moment at which income from the short sale of securities is realised to the moment at which they are returned or the moment on which that return is to take place,

- the removal of many specific exemptions.

[4] Official Journal. WE L 157, p. 38
[5] Journal of Laws of 2000 No. 54, item 654 with subsequent amendments; last amendment: Journal of Laws of 2003 No. 202, item 1957.
[6] Official Journal EC L 225, p. 6

The above amendments do not breach the free movement of goods, persons and capital under the Treaty Establishing the European Community. In principle the provisions hitherto do not breach the above freedom of movement either and comply with art. 92 of the Treaty.

The provision which may be the subject of a dispute before the European Court of Justice is art. 16 para. 7a, pursuant to which, the rules regarding thin capitalisation are not applied in situations where a loan to a company was granted by a taxpayer with its registered office in Poland, excepting situations where the lender is an entity which is exempt from tax because it conducts its activities in a Special Economic Zone. This means that, in fact, for a Polish company interest on a loan granted by a Polish shareholder will always constitute a business expense. However, interest on loans granted by an overseas shareholder will not be such a cost in the event that it meets the thin capitalisation criteria (the lender will be a shareholder holding at least 25% of the company's shares and the value of the loan will be at least three times the share capital). An almost identical regulation under German law was successfully appealed before the European Court of Justice as breaching art. 43 of the Treaty[7].

When it comes to adapting the provisions of the Corporate Income Tax Act to aforementioned Directive 90/435/EEC, this has taken place in art. 20 paras. 2a and 3 and art. 22 paras. 4 and 5 of the Act. The instruments serving to avoid the double taxation of a subsidiary's income which is received by its parent company are:
- exemption from tax on income and income from dividends, if the parent company is situated in a different country to the subsidiary (art. 5 of the Directive),
- elimination of the double taxation of profits received by the parent company from a subsidiary located in a different EU member state, through the application of exemptions or credits (at the discretion of the member state).

The first instrument has been incorporated in the Polish regulations through the introduction of art. 22 paras. 4 and 5. Dividend income and other revenues from participation in a Polish subsidiary is exempt from income tax if all the following conditions are met:

1) the parent company (receiving the dividend) does not have a registered office or a management board in Poland,
2) the parent company is subject to unrestricted taxation in another member country ,
3) the parent company has held not less than 25% of the shares of the subsidiary for an uninterrupted period of not less than two years.

The exemption does not apply if the income is the result of cancellation of the shares in the subsidiary or the sale of the shares for the purposes of cancellation or the liquidation of the subsidiary.

Out of the two alternative methods for avoiding the taxation of the income paid by the subsidiary to the parent company (art. 4(1) of the Directive), the credits method was chosen. When the parent company has its registered office or management board in Poland and has directly held not less then 25% of the shares in a subsidiary situated in another member state for at least two years, an amount equal to the income tax paid in the other member state on that part of the profit from which the dividend was paid will be deducted from the tax payable by the Polish parent company. The total amount of the deduction cannot, however, exceed that part of the tax which was calculated before the deduction and which is proportionally attributable to the income received form that source of income.

The principle of credits is not applicable in cases where these types of revenues are the result of liquidation of the company paying the dividend.

Given the inclusion in the Polish regulations of the requirement to have held at least 25% of the shares for at least two years, the conclusion of the Court in the case of Denkavit[8] may be applicable to them. The formulation of the regulations gives rise to the suspicion that the tax authorities, in the event that the taxpayer makes use of the said solutions, will impose the condition that at the moment of the receipt of the dividend the parent company is in a position to prove that it has held the shares for two years .

The Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (90/434/EEC)[9] is also the subject of incorporation into the Polish tax system. This regulation exempts from taxation capital profits revealed during

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[7] Lankhorst-Hohorst GmbH vs Finanzamt Steinfurt, Case C-324/00, published: www.curia.eu.int

[8] Denkavit International BV, VITIC Amsterdam BV and Voormeer BV vs Bundesamt für Finanzen, Case C-283/94 *European Court reports 1996 p. I-5063*
[9] Official Journal. EC L 225, p. 1 with subsequent amendments.

mergers and de-mergers and the contribution of assets by one company to another, as well as with regard to the exchange of shares with reference to companies which are registered in EU member states.

The above events, at the moment that they occur, do not give rise to a tax liability. The liability is postponed until the moment at which the assets or shares in the company are sold.

Art. 10 paras. 2, 4 and 5 of the Act serves to realise this aim. The provisions, concerning the merger and de-merger of companies, provide that, for the acquiring company or a newly formed one, the increase in value obtained by the acquiring company, or the newly formed one from the target company or being de-merged, over and above the nominal value of the shares attributable to the shareholders of the company being taken over or de-merged, does not constitute income.

In the case of a shareholder of a company which is being taken over or de-merged the nominal value of the shares attributed to him by the acquiring company or the newly-formed company does not constitute income.

However, in the case of an acquiring company which holds shares in the target company or de-merged which account for less than 25% in terms of votes, the income is considered to be the surplus of the value of the assets taken over, proportionally to the shares held in the company being taken over or de-merged, over the costs of sales. This income will be defined on the day that the company taken over or de-merged is deleted from the register or on the day of de-merger.

Hitherto the above principles were applied exclusively to transformations carried out between Polish companies but now they are also being applied where participants in the transformations are companies registered in other member states.
A general clause has been included which does not allow for the use of the above solutions where the takeover or de-merger is not justifiable on economic grounds but it only, or main reason for such a transaction is the evasion or avoidance of taxation. Consequently, the verdict of the European Court of Justice which questioned the right of a member state to declare that a capital transformation was intended to avoid taxation in situations where the internal regulations have not implemented the discretionary provisions of art. 11(1)(a) of the Directive, will not apply to Polish regulations[10].

The amendments to the Act which are intended to further implement the Directive are only in the form of a government draft. As a result of the amendment which, according to the draft, is to come into force on 1 May 2004, the value of shares received in the selling company and in the acquiring company in the case of taxpayers selling shares in one company to another company will not count as income. The conditions for this exemption are as follows:
1. the acquiring and selling companies are subject to unlimited taxation in a member state, and
2. following the acquisition of the shares the acquiring company obtains an absolute majority of votes in the company whose shares are being sold, and
3. in exchange for the shares sold, the selling company receives shares in the acquiring company or receives shares in it together with a cash consideration of not more than 10% of the book value of the shares received.

Thus far Polish regulations have not contained a reflection of the Council Directive of 3 June 2003, on the common system of taxation applicable to interest or royalty payments between associated companies of different Member States (2003/49/EC)[11]. There is only a government draft of an appropriate amendment to the Act, which is supposed to come into force on 1 May 2004. According to this draft interest and licence fees are to be exempt on the following conditions:
1. The payer of the fees is a Polish company or the subsidiary of a company originating from a member state which is located in Poland, if the fees paid by that foreign subsidiary are attributable to costs of sales when calculating the income which is subject to tax in Poland,
2. The company receiving the income is subject to unlimited taxation in a member state,
3. The paying company directly has held not less than 25% of the shares in the receiving company for not less than 2 years, or vice versa or that the company subject to unlimited taxation in a member state directly has held not less than 25% of the shares in both the paying and receiving companies for a period of not less than 2 years,
4. The recipient of the receivables is a company specified in pt. 2 or an overseas subsidiary of that company, if the income resulting from these receivables is subject to taxation in the member state in which the foreign subsidiary is located.

[10] A. Leur-Bloem vs Inspecteur der Belastingdienst/Ondernemingen Amsterdam, Case C-28/95, European Court reports 1997, p. I-4161
[11] Official Journal. EC L 157, p. 49.

4. Tax on civil law transactions

Tax on civil law transactions is charged on certain legal transactions concerning the non-professional market, such as sales, exchanges and loans. Shareholders agreements are also subject to this tax (art. 1 para. 1 pt 1k of the Civil Actions Taxation Act of 9 September 2000[12]). The Act in its current form does not differentiate between the regulations as to the personal or capital nature of the company. Every shareholders agreement and founding deed for a limited liability is encumbered with the civil law transactions tax according to uniform principles. The basis for the taxation is the share capital (in the case of companies) or the value of the contributions (in the case of partnerships). Changes to shareholder agreements which increase the taxation base are also subject to the tax. The Act considers taxable changes to be increases in contributions or in the share capital, shareholder loans in limited liability companies, the donation of items to the company by a shareholder to be used without charge. A regressive tax rate is used with regard to shareholder agreements, beginning with 1% and ending with 0.1% in the case of capital exceeding 30,000 PLN. The regression is maintained in the case of changes to shareholders agreements in that the tax is calculated on the whole of the tax basis following the increase, which is then reduced by the tax previously paid on the given shareholders agreement.

The amendment to the Act, which will come into force on 1 May 2004[13], provides for the retention of the principles for taxing partnerships described above. Companies, on the other hand, (joint stock and limited liability) will be subject to new regulations, pursuant to the Council Directive of 17 July 1969 concerning indirect taxes on the raising of capital (69/335/EEC)[14]. The tax rate has been unified at 0.5% of the taxation basis (this rate also applies to partnerships). The taxation basis does not include shareholder loans and donation of items to the company by a shareholder to be used without charge. In this regard the Polish legislator has decided not to tax these actions, although the Directive, in art. 4(2)(d), includes shareholder loans as discretionary operations which are subject to taxation, on the condition that such a loan has the same effect as an increase in the company's share capital. Verdicts issued by the European Court of Justice also permit the taxation of loans which do not meet the above criteria, if their granting may result in and increase in the value of the company's shares pursuant to art. 4(2)(b) of the Directive[15]. The taxation basis with regard to companies is, according to the Polish regulations, the value of the share capital and in the case of a change to the shareholders agreement – the value by which the share capital has been raised and the amount of shareholders loans. This regulation (with the exception of shareholders loans) refers to the nominal value of the share capital, which raises doubts as to its compliance with art. 5(1)(a) of the Directive, which in determining the tax basis refers to the actual value of the assets contributed and not to the value of the capital. However, given that – as stated in one of the preambles to a directive amending the Directive of 1969[16] - the best solution would be to completely abandon capital taxation; it should be expected that the establishment in the Polish regulations of a method for determining the tax basis which is based on the nominal value of the share capital – which will always be lower than if the point of reference was the value of the assets - will not be questioned as to its compliance with European Law.

The basis for taxation, both in the case of companies and partnerships, pursuant to art. 6 para. 9 of the Civil Law Transactions Taxation Act, shall be reduced by the costs associated with the formation of the company or the raising of its share capital, which complies with art. 5(1)(a) of the Directive. The basis for taxation is also reduced by the value of the contributions, share capital or shareholders loans which had been subject to civil law transaction taxation prior to the transformation of the company. Meanwhile in the case of companies whose registered offices or actual centre of management had been transferred from another member state to Poland, that part of the share capital which had been taxed in another member state will be exempt from taxation (art. 9 pt 11 of the Act). A similar exemption applies to that part of the share capital which was subject to capital taxation through the transformation of the company. These regulations comply with the principle of charging capital tax once.

The new taxation principles, as has been mentioned, are actually only applicable to limited liability and joint stock companies. This means that in calculating the tax on civil law transactions in Poland as regards changes in partnership agreements, which had previously moved its registered office from another member state, the payment of capital tax in that other member state will not be taken into consideration. This does not comply with art. 3(1)(c) of the

[12] Journal of Laws No. 86, item 959 as amended.
[13] Journal of Laws of 2004 No. 6, item 42.
[14] Official Journal EC L 249, p. 25 with amendments.
[15] Verdich In the case of Trave-Schiffahrtsgesellschaft mbH & Co. KG v Finanzamt Kiel-Nord, C-249/89, *European Court reports 1995 p. I*-257.
[16] Council Directive of 10 June 1985 amending Directive 69/335/EEC concerning indirect taxes on the accumulation of capital (85/303/EEC).

Directive, at least regarding partnerships, who in the light of the cited regulation should be treated – for the purposes of the tax on civil law transactions – as ordinary companies.