# Polish equity and debt financing regime in the light of neutrality principle, EC tax law and ECJ case-law

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## 1. Introduction

Shareholders may generally choose between two different methods of company's financing: equity or debt. As a result, the differences between the taxation of dividends and interest payments rise the question whether or not the Polish legal framework guarantees a sufficient level of internal and external neutrality. Internal neutrality assumes similar tax treatment of equity- and debt-financing whereas external neutrality – equal treatment of domestic and foreign-sourced income of the same type[2]. In addition, this paper will focus on the tax aspects of debt and equity financing relevant to EU primary and secondary law and ECJ case law.

## 2. General description of the Polish equity and debt financing tax regime

Poland uses a classic system of dividend taxation.

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[2] B. TERRA, P. WATTEL, *European Tax Law*, Kluwer, 2008, p. 189.

According to the Corporate Income Tax Act (hereinafter: the CIT Act)[3] in purely domestic situations dividend payments are subject to a final withholding tax of 19%.[4] In contrast, resident companies receiving foreign-sourced dividends are obliged to add them to income from other sources (the worldwide taxation principle). In order to eliminate juridical double taxation in this case, Poland grants an ordinary tax credit on per-country basis.[5] These rules do not apply to dividend distribution made by subsidiaries which are residents of the EU, the EEA and Switzerland. Under Polish domestic tax regulations implementing the Parent-Subsidiary Directive (hereinafter: the PSD)[6] Polish resident parent companies receiving dividends from its UE, EEA and Swiss subsidiaries are fully exempt from tax in Poland. The full exemption applies also in cases where the dividend payment is made by a Polish subsidiary to its UE, EEA or Swiss parent company – according to the provisions implementing the PSD, dividends and other profit distributions are fully tax exempt at source if certain conditions are met. In all other situations domestic-sourced dividends paid by a resident company to foreign recipients are subject to a final withholding tax of 19%. Nevertheless, this rate is reduced by virtue of double taxation conventions. Tax treaties concluded by Poland follow the Article 10 of the OECD Model Tax Convention, which means that the rate of withholding tax on outbound dividends may not exceed 5% (in the case of corporate recipients owning at least 25% of shares in the distributing company) or 15% (in all other cases) of the gross income. Under some treaties the single rate of 10% applies instead of two different rates. [7]

Individual resident shareholders receiving domestic and foreign-sourced dividends are subject to a final withholding tax at the rate of 19%. Also Polish-sourced dividends paid to non-resident shareholders are subject to a final

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[3] Corporate Income Tax of 15 February 1992, consolidated text: Journal of Laws of 2000, No. 54, heading 654, amended. About dividend taxation see Arts. 20 and 22 of the CIT Act.
[4] See Art. 22 Sec. 1 of the CIT Act.
[5] See Art. 20 Sec. 1 of the CIT Act.
[6] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225 of 20.8.1990, p. 6–9.
[7] See treaties concluded with e.g. Armenia, Cyprus, China, Georgia, Hungary, Japan, Jordan, Kirgizstan, Mongolia, Russia, Syria.

withholding tax at the rate of 19%, unless a treaty provides otherwise.[8] This uniform tax system regarding foreign and domestic capital income was introduced in 2005 as a consequence of the ECJ rulings in the *Lenz* [9] and *Weidert-Paulus* [10] cases.[11] As far as individuals are concerned the juridical double taxation is also relieved by ordinary tax credit granted on per-country basis.

Rules concerning the taxation of interest in Poland guarantee both the internal and external neutrality. Interest is subject to a final withholding tax at the rate of 20% in case of corporate recipients[12] and at the rate of 19% in case of individuals[13]. Interest paid to non-residents (both corporate and individuals) may be taxed at a reduced rate if a tax treaty concluded with the country of recipient's residence provides so. Then the withholding tax on interest would normally not exceed 10% of the gross income. Under some tax treaties this rate is reduced to 5%[14] or even to 0%[15] - provided that certain conditions set by the tax treaty are met. Resident recipients of foreign-sourced interest are entitled to an ordinary tax credit on per-country basis – as in the case of dividends.

Poland as a EU Member State has implemented respective provisions of the EC Interest and Royalties Directive (hereinafter: the IRD)[16]. However, according to the Council Directive 2004/76/EC of 29 April 2004 introducing the transitional periods referring to the application of the provisions of IRD[17], within the period of

[8] Art. 30a of the Personal Income Tax Act of 26 July 1991 (hereinafter: the PIT Act), Journal of Laws 2000, No. 14, heading 176, amended.

[9] European Court of Justice, Judgment 15 July 2004, case C-315/02, *Annelise Lenz v. Finanzlandsdirektiof für Tirol*, [2004], ECR I-7081.

[10] European Court of Justice, Judgment 13 July 2004, case C-242/03, *Ministre des Finances v. Jean-Claude Weidert, Elisabeth Paulus*, [2004] ECR I7-391.

[11] A. ZALASIŃSKI, *New Member States' Approach to the ECJ's Rulings: The Example of Poland* [in:] C. Brokelind (ed.), *Towards a Homogeneous EC Direct Tax Law. An Assessment of the Member States' Responses to the ECJ's Case Law*, IBFD, 2007, p. 398.

[12] See Art. 21 Sec. 1 of the CIT Act.

[13] See Art. 30a of the PIT Act.

[14] See tax treaties concluded with Armenia, Israel, Lebanon, United Arab Emirates.

[15] See tax treaties concluded with: Austria, Belgium, Denmark, Germany, Ireland, Kuwait, Luxembourg, Mexico, Norway, Spain, Sri Lanka, Sweden, United Kingdom, United States.

[16] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157 of 26.6.2003, p. 49–54.

[17] Council Directive 2004/76/EC of 29 April 2004 amending Directive 2003/49/EC as regards the possibility for certain Member States to apply transitional periods for the application of a common

1 July 2005 and 30 June 2009 Poland was entitled to levy a withholding tax on interest at the reduced rate of 10%. From 1 July 2009 to 30 June 2013, this rate is reduced to 5%. Full exemption will be available thereafter. The reduced rate of withholding tax applies to interest paid between two companies regarded as "associated" within the meaning of the IRD.

Contrary to dividends, interest is fully tax deductible from the debtor's taxable profits. This means that the problem of economic double taxation, which occurs in case of dividends, does not exist if there is an interest payment made by a company to its shareholders. It constitutes a huge advantage of debt financing over equity financing. But the deductibility of interest may be limited in all those cases where domestic thin capitalization rules apply. The impact of these rules will be examined in the subsequent part of this report.

## 3. Tax consequences of different types of shareholders' loans and different types of loans made by subjects other than a company's shareholders

### 3.1. The limitation of deductibility of interest paid to shareholders

Polish tax system does not provide for any differences in taxation of interest arising from various types of loans granted to the company by resident or non-resident shareholders. There are no regulations concerning hybrid financial instruments which blend the elements of equity and debt financing regimes (hidden profit distribution). Common examples of such instruments cover *inter alia* profit participating loans, convertible bonds, back-to-back loans, guaranteed loans and perpetual debts[18]. These instruments are often used by taxpayers as the way of reducing tax burden (tax avoidance). Polish domestic tax law contains

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system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157 of 30.4.2004, p. 106-113.

[18] See: *The Use of Hybrid Financial Instruments in Cross-Border Transactions. Tax Considerations*, KPMG, Amsterdam 1990, p.75; Z. Kukulski, *Niedostateczna kapitalizacja w prawie podatkowym*, C.H. Beck, Warsaw 2006, p. 28-32.

no specific rules limiting deductibility of interest arising from such loans or allowing the re-classification of these payments into dividends for tax purposes. In the *Test Claimants in the Thin Cap Group Litigation* case[19] the ECJ held that domestic rules allowing the re-classification of interest violate the freedom of establishment (Art. 43 of the EC Treaty), especially if they are addressed only to non-residents and the interest-bearing loan was higher than the company's paid-up capital plus taxed reserves. In this area Polish tax system is in concordance with the EC law and the ECJ case law, because, as mentioned above, there are no rules under which re-classification is allowed. Even domestic thin capitalization rules follow this requirement.

In Poland also the general anti-avoidance clause against circumvention or abuse of tax law has a very limited effect on interest payments from any form of hybrid financial instruments. The introduction of such clause in 2003 was widely criticized by the Polish doctrine and judicature as it implies the possibility of broadening interpretation of tax law provisions.[20] For these reasons the general anti-abuse clause was found unconstitutional by the Polish Constitutional Tribunal in the judgment of 11 May 2004 and then abolished[21]. After that ruling the new version of the general anti-abuse clause was introduced into the General Tax Act[22] in Art. 199a, according to which tax authorities are no longer entitled to omit the effects of legal actions undertaken by taxpayers; this right is now reserved only to courts. The application of the general anti-abuse clause as an instrument limiting the deductibility of interest from hybrid financial instruments shall be seen only as a potential threat. By and large, the existence of such

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[19] European Court of Justice, 13th March 2007, case C-524/04,*Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, [2007] ECR I-02107.

[20] See: Judgment of the Supreme Administrative Court of 15 June 2000, I SA/Gd 606/98, not published; B. Brzezinski, *Wykładnia prawa – tzw. obejście ustawy podatkowej. Glosa do wyroku NSA z dnia 31 stycznia 2002 r., I SA/Gd 771/01*, Monitor Podatkowy 2002, No. 6, p. 50, M. KALINOWSKI, *Granice legalności unikania opodatkowania w polskim systemie podatkowym*, Toruń 2001, pp. 13-22, Z. KUKULSKI, *Niedostateczna…*, *op. cit*, pp. 16-35.

[21] See Judgment of the Constitutional Tribunal of 11 May 2004, Case K 4/03, OTK 1994, No. 1, Sec. 22; See also: T. DĘBOWSKA-ROMANOWSKA, *Dopuszczalność i warunki wprowadzenia klauzul generalnych zakazujących obejścia i nadużycia prawa w systemie prawa podatkowego – w świetle art. 84 i 217 Konstytucji*, [in:] *Księga pamiątkowa ku czci Prof. A. Kabata*, Wydawnictwo *Ius et* Lex, Warsaw 2004, p. 102 .

[22] General Tax Act of 29 August 1997, Journal of Laws 2005, No. 8, heading 60, amended.

clause does not violate the freedom of establishment. In its decisions in the *Cadbury Schweppes* case[23] and the *Thin Cap Group Litigation* case[24], the ECJ emphasized that the need to prevent tax avoidance might justify restrictions concerning the freedom of establishment especially when taxpayers undertake wholly artificial arrangements designed to circumvent the legislation of the respective Member State. In the ECJ's opinion, the mere fact that a loan is granted to a resident company by a related company resident in another Member State does not mean that a circumvention of the former Member State's legislation appears. This fact cannot be a basis for a general presumption of an abusive practice and cannot justify the restriction[25].

### 3.2. The conformity of the Polish thin capitalization rules with the EC law and the ECJ case law

When analyzing tax consequences of loans made by shareholders and by subjects other than a company's shareholders it is important to focus on thin capitalization rules (hereafter: TCR)[26.] These rules limit the deductibility of interest paid by a company only if such interest arises from loans provided by shareholders.[27] Basically they do not apply to interest on loans made by other subjects. Poland has introduced TCR to its domestic tax system in 1999[28]. Initially Polish TCR were not in line with the freedom of establishment as they

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[23] European Court of Justice, Judgment 12 September 2006, case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, [2006] ECR I-7995.
[24] European Court of Justice, 13th March 2007, case C-524/04,*Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, [2007] ECR I-02107.
[25] See also: European Court of Justice, Judgment 21 February 2006, case C-255/02 *Halifax plc and Others v Commissioners of Customs & Excise*, [2006] ECR I-1609; ECJ, Judgment 21 February 2006, case c-419/02, *BUPA Hospitals Ltd v. Commissioners of Customs & Excise*, [2006] ECR I-1685 and ECJ, Judgment 21 February 2006, case C-223/03, *University of Huddersfield Higher Education Corporation v Commissioners of Customs & Excise*, [2006] ECR I-1751.
[26] R.A. SOMMERHALDER, *International Approaches to Thin Capitalization*, *European Taxation* 1996, No.3, p. 82; Z. KUKULSKI, *Niedostateczna…*, pp. 87 – 90.
[27] *Report on Thin Capitalization*, *Issues in International Taxation*, No. 2, OECD, Paris1987; D. Plitz, *International Aspects of Thin Capitalization: General Report* [in:] *Studies on International Fiscal Law*, Vol. LVVVIb, Kluwer 1994, p. 87.
[28] See: Art. 16 Sec. 1 points 60 and 61 and Art. 16 Sec. 6, 7 and 7a of the CIT Act.

were applicable only to interest arising from loan agreements provided by non-resident shareholders and resident shareholders exempt from CIT. Therefore resident shareholders liable to corporate income tax in Poland were put outside the scope of TCR. In the context of the ECJ ruling in the *Lankhorst–Hohorst* case[29] the scope of Polish TCR was amended. Since 2005 they have covered both cross-border and domestic situations.[30]

Poland limits the deductibility of interest in case of thin capitalization if the balance between equity capital and debt capital provided by shareholders to a company exceeds the *debt-to-equity ratio* of 3:1. Within these limits shareholders are allowed to finance their company by debt capital without any restrictions. Polish TCR do not provide for the re-classification of interest into dividends for tax purposes. That being so, Polish TCR are compatible with the EC law and the ECJ case law, especially in the light of the ECJ's judgments in the *Test Claimants in the Thin Cap Group Litigation* case[31] and the *Lammers & Van Cleeff* case[32].[33]

The TCR in Poland restrict the deductibility of interest if it arises from loans (credits) granted to a company by a group of its shareholders who have the status of "qualified lenders": both individuals and corporate entities. This "qualified lender" is a direct shareholder owning at least 25% of the share capital of a thinly capitalized company. However, interest arising from loans provided by a group of direct shareholders owning in aggregate at least 25% of the share capital also falls under the scope of Polish TCR. Moreover, loans made between companies in which another company owns directly at least 25% of the share capital are covered by Polish TCR. In all above-mentioned situations the

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[29] ECJ, Judgment 12 December 2002, case C-324/00, *Lankhorst – Hohhorst GmbH v Finanzamt Steinfurt,* [2002] ECR I-11779().

[30] See: F. ŚWITAŁA, *O dostosowaniu ustawy o CIT do dyrektyw unijnych*, Przegląd Podatkowy 2004, No. 7, p. 33; Cf. A. Kośmider, *Odsetki od pożyczki udzielonej spółce kapitałowej przez jej wspólnika*, Przegląd Podatkowy 2004, No. 6,p. 12.

[31] ECJ, Judgment 13 March 2007, case C-524/04,*Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, [2007] ECR I-02107.

[32] ECJ, Judgment 17 January 2008, case C-105/07, *NV Lammers & Van Cleeff v Belgische Staat*, [2008] ECR I-00173.

[33] See also: Ł. ADAMCZYK [in:] H. LITWIŃCZUK (ed.), *Podatki bezpośrednie. Prawo polskie a prawo wspólnotowe*, Wiedza i Praktyka, Warsaw 2009, p. 390.

minimum of 25% direct shareholding is determined on the basis of the number of votes (voting power) which can be attributed to these shares.

From 2005 different types of loans provided by shareholders fall under the scope of application of TCR in Poland.[34] The term "loan" covers: not only any contract according to which the lender commits himself to transfer the property rights to a specific sum of money to the borrower and the borrower commits himself to pay back the same sum of money, but also the emission of debt securities, the irregular deposit and the bank deposit. This definition applies solely for the purposes of TCR and does not provide the general concept of "loan" for the whole domestic tax system.

For the purposes of calculation of the *debt-to-equity ratio*, the comparison of the value of company's equity and the value of its debts is necessary. The present TCR may violate the ability to pay of the thinly capitalized company. The measures governing the calculation of acceptable *debt-to-equity ratio* are strongly in favor of equity financing. They artificially decrease the value of company's equity. According to domestic TCR the nominal value of the company's equity is not taken into account. Following parts of the equity are excluded when calculating the level of the *debt-to-equity ratio:* (a) the one which was not actually contributed (paid) by the shareholders, (b) the one which was covered by loans, credits and interest on such loans and credits granted by the shareholders and converted into company's share capital and (c) the one which was covered by tangibles and intangibles from which depreciation allowances are not allowed according to the CIT Act (i.e. immovable property, buildings) [35].

On the other hand, there are no measures providing how the value of company's debts has to be calculated. The lack of proper regulations leads to the conclusion that it ought to be understood in the broadest sense as the total value of all company's debts provided by a group of shareholders who can be regarded as "substantial shareholders". This is a different category of shareholders than "qualified lenders" as described above. The group of "substantial shareholders"

[34] Art. 16 Sec. 7b the CIT Act.
[35] Art. 16c of the CIT Act.

includes direct shareholders who own at least 25% of the company's share capital ,as well as indirect shareholders with at least 25% share in the equity of the company's direct shareholder. Direct shareholders who in aggregate own at least 25% of company's equity are not deemed as "substantial". Loans made by this group of shareholders are not added to the company's debts in the process of calculation of the *debt-to-equity ratio.* However, it must be emphasized that interest paid by a company to indirect "substantial" shareholders does not follow under the restrictions provided by the TCR. Such interest is fully tax deductible even if the *ratio* is exceeded. These provisions infringe the internal neutrality principle since they differentiate between loans granted by direct and indirect shareholders.

## 4. Compliance of the Polish domestic equity and debt financing tax regime with EC law and ECJ case law

### 4.1. General remarks

As it was already mentioned, a tax system is neutral when it guarantees a similar tax treatment of equity- and debt-financing (internal neutrality) and provides equal taxation of domestic and foreign-sourced dividends and interest (external neutrality). Within the European Union the neutrality principle has an impact on the EC fundamental freedoms: the freedom of establishment (Arts. 43 - 46 of the EC Treaty), the free movement of capital (Arts. 56 - 60 of the EC Treaty) and the principle of non-discrimination on the grounds of taxpayer's nationality (Art. 12 of the EC Treaty)[36]. The EC law prohibits any form of discrimination based on the place of residence either of companies or shareholders. Therefore a Member State which applies different rules of taxation to comparable situations or the

[36] See D. WEBER, *Tax Avoidance and the EC Treaty Freedoms. A Study of the Limitations under European Law to the Prevention of Tax Avoidance*, Kluwer Law International, 2005, pp. 26-30.

same rules to different situations discriminates and/or may violate the fundamental EC Treaty freedoms.

### 4.2. The elimination of economic double taxation of dividends in Poland in the light of EC law and ECJ case law

A classic system of taxation ignores the fact that profits from which dividends were actually paid were also taxed before the distribution - at the level of the company. The existence of economic double taxation causes that the equity financing seems to be less attractive from taxpayers' point of view. In order to eliminate this problem countries may exempt dividends from the withholding tax or grant a credit for the corporation tax levied at the company level before the distribution of dividends (so-called credit for underlying tax). The first method is applied in countries belonging to the classic system of taxation. The exemption is usually available only to corporate shareholders holding certain percentage of company's shares or votes (affiliation privilege)[37]. The credit for underlying tax method is used by countries applying the full or partial imputation system. From the international point of view the imputation system does not seem to be neutral, because the credit for underlying tax is usually not granted for dividends paid to non-resident shareholders, although some countries extend its application to foreign shareholders under bilateral tax treaties.[38] Therefore the imputation system was found by the ECJ incompatible with the freedom of establishment and the free movement of capital. In the cases *Lenz*[39], *Manninen*[40] and *Meilicke*[41], the Court pointed out that the granting of imputation credits cannot be limited purely to the domestically sourced dividends without

[37] B. TERRA, P.WATTEL, *European…*, *op. cit*, p. 181.
[38] *Ibidem*, pp. 185-186.
[39] ECJ, Judgment 15 July 2004, case C-315/02, *Anneliese Lenz v Finanzlandesdirektion für Tirol*, [2004] ECR I-07063.
[40] ECJ, Judgment 7 September 2004, case C-319/02, *Petri Manninen*, [2004] ECR I-07477.
[41] ECJ, Judgment 6 March 2007, case C-292/04, *Wienand Meilicke, Heidi Christa Weyde and Marina Stöffler v Finanzamt Bonn-Innenstadt*, [2007] ECR I-01835.

infringement of the EC fundamental freedoms.[42] The same opinion was held in the *Test Claimants in Class IV of the Act Group* and *Test Claimants in the FII Group Litigation* cases[43].

From January 2008 Poland applies an exemption as the main method for elimination of economic double taxation of dividends made between parent companies and their subsidiaries. From 1 May 2004 to 31 December 2007 the economic double taxation was eliminated by the credit for underlying tax method.

The current Polish tax system is in concordance with the EC fundamental freedoms and with the ECJ case law. Dividends paid by resident subsidiaries to their resident parent companies are exempt from withholding tax if the parent company holds at least 10% of the shares in the subsidiary continuously for at least 2 years[44]. The same rule applies if the dividend distribution is made by a Polish subsidiary to its EU parent company (or its permanent establishment), its EEA parent company or its Swiss parent company. As in the case of resident parent companies receiving dividends from their resident subsidiaries, the EU and the EEA parents are exempt from withholding tax if they hold at least 10% of the shares in the subsidiary continuously for at least 2 years. The Swiss company is entitled to the exemption, if it holds 25% instead of 10% of shares in the subsidiary. It must be emphasized that the rules providing the condition of uninterrupted 2 years period of holding subsidiary's shares were constructed in line with the ECJ *Denkavit cases*[45]. According to Art. 20 Sec. 10 and Art. 22 Sec.

[42] *Ibidem*, p. 186.

[43] ECJ, Judgment 12 December 2006, case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* [2006] ECR I-11673; ECJ, Judgment 12 December 2006, case C-446/04, *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue*, [2006 Page] ECR I-11753.See also: the EFTA Court in the case E-1/04; the *Fokus Bank*; ECJ, Judgment 3 April 2008, case C-27/07, *Banque Fédérative du Crédit Mutuel v Ministre de l'Économie, des Finances et de l'Industrie*, [2008] ECR I-02067 and ECJ, Jedgment 25 September 2003, case C-58/01, *Océ van der Grinten NV and Commissioners of Inland Revenue*, [2003] ECR I-09809.

[44] According to Art. 20 Sec. 11 of the CIT Act this rule does not apply if the dividend payment was made as the result of liquidation of the distributing company.

[45] Joint ECJ, cases C-284/94, C-291/94 and C-292/94, *Denkavit International BV and VITIC Amsterdam BV and Voormeer BV v. Bundesamt fűr Finanzen* (), [1996] ECR I-5063-5104; See E. PREJS, *Orzecznictwo Europejskiego Trybunału Sprawiedliwości na tle dyrektyw wspólnotowych w zakresie podatkowa bezpośrednich*, Kwartalnik Prawa Podatkowego 2002, No. 3/4 , pp. 70-72 and

4b of the CIT Act the parent company is still entitled to the exemption even if the period of uninterrupted holding of shares in the subsidiary ends after the date of receiving the dividend income. The same rule applies in case of interest payments made between associated companies, according to Art. 21 Sec. 5 of the CIT Act implementing the provisions of the IRD.

However, the credit for underlying tax method still applies in case of third country-sourced dividends. Polish resident parent company (holding at least 75% of shares in the distributing company) receiving dividend payments from its subsidiary resident of a country, which is not a EU, EEA Member State or Switzerland, is allowed to deduct the amount of tax which was paid in the third country by the distributing company before the distribution. Nonetheless, such deduction may not exceed that part of tax, as computed before the deduction is given, which was proportionally attributable to the income from the foreign source[46]. This deduction is available if there is a tax treaty concluded between Poland and the source country of dividends.

## 4.3. The elimination of juridical double taxation of dividends and interest in Poland in the light of EC law and ECJ case law

The existence of international juridical double taxation of dividends and interest violates the tax neutrality. In order to eliminate this problem each country may, unilaterally or on the ground of bilateral tax treaties, limit its tax sovereignty either by exempting from taxation certain types of income received from foreign sources and/or paid by residents to foreign recipients (the exemption method) or grant a tax credit to resident recipients of foreign-sourced income for the withholding tax collected at source (the tax credit method). These two methods of elimination of juridical double taxation originate from different neutrality concepts: home market neutrality (the credit tax method) and source market

F. ŚWITAŁA, *O dostosowaniu…, op. cit.*, p. 29;ee also: H. LITWIŃCZUK [in:] H. LITWIŃCZUK (ed.), *Podatki bezpośrednie…, op.cit.*, p. 48.

[46] See Art. 20 Secs. 2 and 6 of the CIT Act.

neutrality (the exemption method)[47]. It must be pointed out that the EC primary law contains no rules concerning the question how the two Member States should eliminate juridical double taxation. Moreover, in the its case law, the ECJ admits that the EC Treaty freedoms are not capable of preventing international double taxation (case *Kreckhaert-Morres*[48])[49]. In order to eliminate juridical double taxation of dividends and interest the secondary EC law (the PSD and the IRD) provides the exemption method. According thereto the EU Member States are not allowed to impose a withholding tax on dividends paid to non-resident parent companies and at the same time grant almost full exemption from such a tax to resident companies. In the ECJ's opinion expressed in the *Denkavit Internationaal BV* and *Denkavit France SARL* case[50] such rules constitute a discriminatory restriction on the freedom of establishment and the free movement of capital. The same position was taken in the *Aberdeen* case[51].

As mentioned above, Poland grants tax credit for passive investment income derived from foreign sources. However, the exemption method applies in respect of dividends paid by a Polish subsidiary to its EU, EEA or Swiss parent company (or its permanent establishment) if the EU or the EEA parent company holds at least 10% of shares in the Polish subsidiary continuously for at least 2 years. In case of the Swiss parents the minimum holding requirement is at least 25% of the subsidiary' shares. Polish domestic provisions can be found in accordance with the ECJ decision of 8 November 2008 in the *Amurta* case[52]. They do not provide for a withholding tax on dividends distributed by a Polish resident company to a company established in another Member State and at the same time exempt from that tax dividends paid to a resident company if the minimum

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[47] B. TERRA, P.WATTEL, *European…, op.cit.*, p. 174.

[48] ECJ, Judgment 14 February 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*, [2006] ECR I-10967.

[49] *Ibidem*, p. 174.

[50] ECJ, Judgment 14 December 2006, case C-170/05 *Denkavit Internationaal BV and Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie* [2006] ECR I-11949.

[51] ECJ, Judgment 18 June 2009, case C-303/07, *Aberdeen Property Fininvest Alpha Oy*, [2009] ECR 00000.

[52] ECJ, Judgment 8 November 2007, case C-379/05 *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam*, [2007] ECR I-09569. About the case see: E.C.C.M. KAMMEREN, *Pending Case Filed by Dutch Courts I: The Amutra Case* [in:] M.LANG, J.SCHUCH, C. STARINGER (eds), *ECJ – Recent Developments in Direct taxation 2007*, Linde, Vienna 2008, pp. 139- 166.

threshold for the parent company's shareholdings in the share capital of the subsidiary set up in the PSD is not reached. In Poland the minimum shareholding of 10% of shares in the distributing company is a condition for the application of the exemption both in domestic and foreign situations.

Polish tax law does not contain any rules concerning the "controlled foreign companies" taxation (CFCs rules). In this field the Polish tax system is compatible with the EC law and the ECJ case law.[53] Only the list of taxpayers covered by the rules implementing the PSD seems to be too narrow in the context of the ECJ judgment in the *Aberdeen* case. In this judgment the exemption was extended also to dividends paid to a parent company established in a form of an open-ended investment company residing in another Member State and its legal form was unknown in the legal system of the source country and did not appear in the list of companies referred to in the PSD[54].

The domestic rules governing the elimination of juridical double taxation of interest payments are compatible with the EC primary and secondary law. Interest paid to non-residents is subject to withholding tax. The rate of this tax differs depending on bilateral tax treaty provisions (see: Sec. 1 - General description of the Polish equity and debt financing tax regime). In case of interest payments made by Polish residents to associated companies within the meaning of the IRD, Poland is entitled to levy a withholding tax at the reduced rate of 5% until 30 July 2013, after this date the full exemption provided by the Directive will apply. According to Art. 21 Sec. 3 of the CIT Act two companies are associated if: (a) they have a legal form listed in the Annex to the IRD, (b) they are subjects to a CIT in two different Member States and (c) one of them holds directly at least 25% of the capital of the other or a third EU company holds directly at least 25% of the capital in both of them. Poland applies an ordinary tax credit for foreign-sourced interest. These regulations seem completely in

[53] See: ECJ, Judgment 12 September 2006, case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, [2006] ECR I-07995 .
[54] See: H. LITWIŃCZUK [in]: H. LITWIŃCZUK (ed.), *Podatki…*, op. cit., p. 484.

accordance with the ECJ case law, especially with the *Aberdeen* case[55] and the *Truck Center* case[56].

### 4.4. Conformity of Polish capital duty regulations with EC law

Capital taxes are harmonized to a certain extent by way of the Directive 2008/7/EC[57], which replaced the Directive 69/335/EC[58]. As Poland applies a particular capital duty aimed at civil law transactions, Polish capital duty regulations (i.e. respective provisions of the Tax on Civil Law Transactions Act, (hereinafter: the PCC Act)[59]) are therefore bound to be in line with EC law. Two important issues arising in the context of the application of the PCC Act and concerning both the equity and debt-financing regimes will be discussed in this section.

#### 4.4.1. Taxation of loans granted by a shareholder to a company

It seems that the regulation being in force from 1 January 2007, which introduced the taxation of loans given by a shareholder to a company was contrary to the respective provisions of the Directive 69/335. Article 4 Sec. 2 letter c of the Directive permitted Member States to tax loans given by a shareholder to a company. However at the same time art. 7 Sec. 1 of the Directive provided for an obligatory exemption of transactions exempted on 1 July 1984 or taxed at the rate of 0,5% or lower.

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[55] ECJ, Judgment 18 June 2009, case C-303/07, *Aberdeen Property Fininvest Alpha Oy*, [2009] ECR 00000.
[56] ECJ, Judgment 22 December 2008, case C-282/07, *Belgian State - SPF Finances v Truck Center SA.* [2008] ECR 00000.
[57] Council Directive 2008/7/EC of 12 February 2008 concerning indirect taxes on the raising of capital, OJ L 46 of 21.02.2008, p. 11.
[58] Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital, OJ L 249, of 3.10.1969, p. 25.
[59] Tax on Civil Law Transactions Act of 9 September 2000, Journal of Laws 2000, No. 86, heading 959, amended.

#### 4.4.2. Taxation of contributions in kind

According to Art. 4 Sec. 1 letter c of the Directive 69/335 an increase in the capital of a capital company by contribution of assets of any kind was subject to capital duty. Nevertheless, as it was mentioned above, it was not admissible if on 1 July 1984 a respective kind of civil law transaction was exempt from tax or taxed at the rate of 0,5% or lower.

#### 4.4.3. The significance of the 1 July 1984 date for the conformity of Polish capital duty with the EC law

An issue of a decisive character is the interpretation of Art. 7 Sec. 1 of the Directive 69/335, i.e. the significance of that date for Poland and the question: whether the exemption provided by that provision pertains to transactions exempted then on the basis of the Directive or only on the basis of domestic tax law. It has to be noted that in Poland both contributions in kind and loans given by a shareholder to a company were subject to capital duty on 1 July 1984 and were taxed at the rate higher than 0,5%.

When analyzing the compliance of Polish law with Art. 7 of the Directive 69/335 it is not essential that in 1984 Poland was not a member of the European Community. This opinion is supported by two judgments of the ECJ: in the *Optimus* case[60] and in the *Commission v. Spain* case[61]. In these judgments the Court ruled that Art. 7 of the Directive is binding also on the States that became members of the European Union after the year 1984. However, accession treaties or other Community acts may contain particular reservations.

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[60] ECJ, Judgment 21 June 2007, case C-366/05 *Optimus – Telecomunicaćoes S.A. v. Fazenda Pública*, [2007] ECR I-04985.
[61] ECJ, Judgment 9 July 2009, case C-397/07, *Commission of the European Communities v Kingdom of Spain*, [2009] ECR 00000.

Nevertheless, it must be emphasized, that in case of Poland no such provisions were introduced to the Accession Treaty[62].

In the *Optimus* case the ECJ explained that Art. 7 Sec. 1 of the Directive refers to the exemptions existing in the respective Member State, which, however, does not limit the scope of that provision but, on the contrary, widens the application of the exemption provided for in Art. 7 Sec. 1. The *Optimus* case shall be construed in a way that it allows to apply the exemption provided by Art. 7 Sec. 1 not only to transactions exempt on the basis of the Directive 69/335 but also to transactions exempt pursuant to domestic tax law[63].

## 5. Final remarks

The Polish equity and debt-financing tax regimes seem to be neutral from international point of view. In purely domestic situations the economic double taxation of company's distributed profits discriminates against equity-financing in comparison with debt-financing as rules providing the exemption apply only to corporate shareholders (parent companies) receiving dividends from their subsidiaries located either in Poland or in the EU, the EEA countries and Switzerland. Those rules however do not cover payments concerning neither individuals nor corporate shareholders owning less than 10% of subsidiaries' shares.

Also the Polish domestic tax law does not recognize different types of loans granted to a company by its shareholders. There are no rules according to which in some specific situations such loans would be regarded as hidden profit distribution and in consequence interest from such loans would be re-classified for tax purposes into dividends. This encourages the shareholders to choose the debt- instead of equity-financing. The advantages connected with the debt-

[62] Accession Treaty of 16 April 2003, OJ L 236 of 23 September 2003, pp. 17.

[63] See also ECJ, case C-197/94 *Société Bautiaa v Directeur des Services Fiscaux des Landes and Société Française Maritime v Directeur des Services Fiscaux du Finistère*. ECJ, Judgment 30 March 2006, case C-252/94 and case C–46/04, *Aro Tubi Trafilerie SpA v Ministero dell'Economia e delle Finanze*, [2006] ECR I-03009.

financing are not limited by the application of the domestic thin capitalization rules. According to these rules the *debt-to-equity ratio* is calculated at the moment the interest is paid to company's shareholders, so these restrictions can be easily avoided if a company pays off some of its debts before this moment. Also the general anti-abuse clause has a limited application to shareholders' loans as tax authorities are demanded to collect evidence proving the wholly artificial character of transactions designed and undertaken by the taxpayers for the circumvention of tax provisions. The matter whether there is a circumvention of tax provisions or not may be decided only after a court determines that certain right or legal relation exists or not. This is a very time-consuming process.

The Polish equity- and debt-financing regimes seem to be compatible with the EU legal order and the ECJ case law, although the Polish legislator has not taken any particular actions to ensure this compatibility.[64] However, amendments were made of the CIT provisions related to dividend payments made between parent companies and their subsidiaries (the *Denkavit* cases) and thin capitalization rules (the *Lankhorst-Hohorst* case). The other examples of the direct consequences of the ECJ case law are the changes of the PIT provisions concerning the application of the flat rate of withholding tax both to domestic and cross-border dividends and interest - in order to comply with the ECJ's rulings in the *Lenz* and *Weidert-Paulus* cases.

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[64] A. ZALASIŃSKI, *Polish Direct Tax Provisions Potentially Incompatible with EC Fundamental Freedoms*, European Taxation 2006, No. 5, pp. 225-229; A. ZALASIŃSKI, *New Member States' Approach…, op.cit.,* p. 393. See also W. NYKIEL, T. KARDACH, *Poland: The Uwe Rüffler Case*, [in:] M. LANG, P. PISTONE, J. SCHUCH, C. STARINGER (eds.), *ECJ Recent Developments in Direct Taxation 2008*, Vienna 2008, pp. 319..