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Changes to the CIT Act to be implemented as of 2020 – counteracting tax optimization using hybrid structures

On August 23, 2019, the Project of the bill amending the CIT Act, the Act on the exchange of tax information with other countries and certain other acts dated August 22, 2019 has been published on the Government Legislation Centre website (hereinafter: the "Project").

The proposed Project is aimed, among others, to further implement the ATAD Directive laying down rules against tax avoidance practices, as well as the ATAD 2 Directive amending it as regards discrepancies in the qualifications of hybrid structures, expanding its scope to third countries from outside the EU. In a nutshell, the aforementioned directives are the result of works carried out in the recent years on the international forum, in particular by the OECD in respect of the BEPS project.

As indicated, the purpose of introduction of the new regulations is to increase the resilience of the Polish market, and thus the internal EU market, to discrepancies in the qualifications of the hybrid structures.

New Chapter 3a of the CIT Act

The Project introduces a new Chapter 3a to the CIT Act. Within it, several regulations have been included concerning **the issue of discrepancies in the classification of economic entities by various tax jurisdictions** (the so-called hybrid entities, treated for tax purposes as transparent in one jurisdiction and at the same time as non-transparent in another) as well as **payments** (including hybrid instruments that in one jurisdiction may be considered as an equity

instrument and in the other as a debt instrument, e.g. participatory loans or convertible bonds), which may lead to different treatment of revenues and costs recognized by the taxpayers for tax purposes. In addition, the proposed new Chapter 3a contains a separate glossary which defines specific terms used in the introduced regulations (e.g. definitions of a hybrid financial instrument, hybrid entity or structural arrangement).

The most important changes relate to the following issues:

Double deduction of costs or deduction of costs without recognition of taxable revenues on the other side

According to the Project, the key purpose of implementing the new regulations is to counteract situation of double tax deduction of costs or deduction without recognition of corresponding revenues.

The new regulations indicate certain cases in which the taxpayer will not be entitled to recognize tax deductible costs on payments, which are subject to double deduction, i.e. deduction from the tax base in more than one tax jurisdiction.

The taxpayer will also not be allowed to recognize as tax deductible costs payments that are deductible from the tax base in one jurisdiction, without corresponding inclusion of this payment in the tax base of the taxpayer in another jurisdiction.

The taxpayer will also be required to recognize as taxable revenues the amount of receivables obtained, even if they are excluded for tax purposes under other provisions of the CIT Act.

These restrictions and obligations will apply to specific situations set forth in the new regulations.

In addition, the obligations to exclude payments from tax deductible costs or to classify them as taxable revenues will occur only if the deduction without taxation has been made by related entities or under a structural arrangement.

Moreover, in general, the above restrictions will also apply to payments directly or indirectly used to finance expenses that result in discrepancies in the qualifications of hybrid structures.

Dual resident mismatches

The subsequent provisions refer to the case of the entity's double tax residence, i.e. the situation where two countries treat a particular entity as subject to unlimited tax liability. In such a case, a taxpayer recognized under the Polish tax law as a Polish tax resident will not be entitled to report payments as tax deductible expenses or to reduce income by the amount of tax losses, if such expenses or tax losses:

- are deductible in at least two countries in which the taxpayer is treated as tax resident,
- do not correspond with the double reported income (revenue).

Disregarded permanent establishment

Under the proposed provisions, in a situation where a foreign permanent establishment of a Polish tax resident is not treated as a foreign permanent establishment by the country of its location (the so-called

"disregarded permanent establishment"), the taxpayer's taxable revenues will be increased by the revenues that could be attributed to this permanent establishment, if it would be treated as a foreign permanent establishment by the state of its location.

However, this regulation will not apply if the obligation to apply exemption to the income of the disregarded foreign establishment will result from a double tax treaty in force between Poland and another non-EU country.

New specific anti-avoidance rule

In addition to the changes indicated above, the Project introduces new specific anti-avoidance clause which will restrict the taxpayers' right to increase tax deductible costs by the notional external financing costs in connection with additional shareholder payments or profit transferred to reserve or supplementary capital (the so-called notional interest deduction – NID), applicable under Article 15cb of the CIT Act in force since 2019.

Under the proposed paragraph 10 to the described Article, this entitlement will not apply when the indicated activities would be carried out without economically justified reasons but mainly or solely for the purpose of obtaining a tax benefit (e.g. by making an additional shareholder payment to a company which will then transfer funds from this first payment to another or subsequent company as part of the second or subsequent payment).

Entry into force

The above provisions shall enter into force on January 1, 2020.

As a rule, until this date the EU countries have been obliged to implement the provisions of the ATAD Directive 2 into their national law.

The only exception in this respect is the deadline for implementation of the ATAD 2 Directive regulations concerning discrepancies in the qualifications of inverted hybrid structures, which has been postponed to January 1, 2022.

Other changes envisaged in the Project

In addition to the new regulations mentioned above, the Project also introduce further transposition of the so-called MDR Directive on reporting tax patterns into the Polish legal order. This topic will be described in more detail in a separate publication from the Tax Alert series.

Recommendations

According to the justification to the Project, its principal objective is to tighten the existing corporate income tax system. However, the impact of the planned amendments on the situation of taxpayers requires an individual case-by-case analysis.

Please contact us if you would like to obtain more information on Project or discuss its impact on future tax obligations of your company as well as any possible changes in current business activity model to be best prepared for the new law.

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