



# Frontiers in tax

**Poland Edition**

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**In this Issue:**

- Business substance and withholding tax
- Mergers: tax neutrality no longer so certain
- Controversy related to debt-push-down structures
- Warranties and indemnities in share purchase agreements
- Tax aspects of price adjustments in M&A transactions
- MDRs and M&As: the moment of reporting a tax scheme
- The implications of Brexit and tax aspects of mergers and acquisitions

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# In this Issue

**Introduction**

5

**Business substance and withholding tax**

7

**Mergers: tax neutrality no longer so certain**

10

**Controversy related to debt-push-down structures**

15

**Warranties and indemnities in share purchase agreements**

18

**Tax aspects of price adjustments in M&A transactions**

23

**MDRs and M&As: the moment of reporting a tax scheme**

26

**The implications of Brexit and tax aspects of mergers and acquisitions**

31

**KPMG Publications**

34

**Contact**

35









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The recent pace of changes in last 5 years introduced to tax legislation makes it necessary to revise the approach to M&A transactions.

It is becoming increasingly important to ensure the adequate safeguards against tax risks in such transactions. Taxes have become a critical factor and cannot be considered only as a compliance topic and must be carefully considered in any such transaction. Tax matters are addressed particularly in share purchase agreements (SPAs) and, sometimes, in Tax Deeds. For their own benefit, the investors should establish the presence of adequate tax warranties and indemnities in their deals. The tax risks involved in a deal can sometimes be so significant that they are reflected in the transaction price.

The impact of the withholding tax risk on the transaction process should be investigated both during the tax due diligence and when designing the structure of the deal. Withholding tax has always been an essential aspect of M&A transactions, but with changes to tax regulations in Poland and their practical application, the related risk is currently higher.

What is new in the M&A world is that some transactions may have to be reported as tax arrangements in accordance with MDRs. This is a challenging subject in terms of interpreting the applicable regulations, the first problem being the obligation to report a tax arrangement when the parties to the transaction are bound by non-disclosure agreements.

The recent changes to tax regulations may also adversely affect the position of acquiring companies in merger processes. In response, mergers should be structured in such a way as to mitigate the risk of such restructuring processes being liable to tax.

Companies planning to complete restructuring transactions involving UK-registered companies should certainly quicken their pace. When the transition period ends, the UK will no longer be bound by EU directives, so some restructuring processes involving UK companies may be liable to tax.

Enjoy reading this issue of Frontiers in Tax, where you will find our discussions of the significant tax aspects of M&A transactions.





# Business substance and withholding tax

**The withholding tax collection rules were changed at the beginning of 2019. One of the changes was made to the definition of beneficial owner, by adding a new requirement - an actual performance of business activity within the country of establishment if its receivables are connected with the conduct of such business.**



Although some of the amended provisions will not become effective before 30 January 2020, since 1 January 2019 withholding tax remitters have been required to exercise the due care if they aim to apply preferential withholding tax treatment (e.g. exemption from tax or a reduced withholding tax rate under a double tax treaty). Consequently, a Polish withholding tax remitter is required to verify whether the beneficiary of a payment may be considered as the beneficiary owner of the payment, and this verification should include also its business substance.

To determine whether an entity actually conducts a business activity, it is necessary to consider the Corporate Income Tax Act provisions (or, as the case may be, the Personal Income Tax Act) governing controlled foreign companies ("CFCs"), where the new requirement has been defined for income tax purposes. Importantly, although the purpose of the beneficial owner provisions is different than that of the CFC provisions, both are intended to prevent the same type of violation, including the use of artificial companies and/or artificial transactions in tax settlements.

According to the draft document on withholding tax guidelines dated 19 June 2019 ("Explanatory Notes"), the fact whether an entity actually conducts a business activity in a particular country and whether or not the entity is eligible for any of the preferential tax treatments provided for in the relevant double tax treaty ("Tax Treaty"), should be determined by the existence of that entity's property and personnel substance within that country.

A lack of such substance in the entity's country of establishment may indicate that the entity does not conduct a business within that country. This, in turn, may indicate the existence of an artificial business structure which, in accordance with OECD's guidelines, should not enjoy the benefits of a Tax Treaty (e.g. a reduced tax rate).

Given the above, when assessing whether or not an entity actually conducts a business activity, it is necessary to consider, in particular, whether

- a. a business undertaking exists in that country as part of which the entity is actually engaged in activities that may be considered as business activities. This includes, in particular, whether the entity has any business premises, qualified personnel or equipment used in the conduct of business activities;
- b. the entity does not maintain any structures other than for economic reasons;
- c. the scale of the business conducted by the entity is proportionate to the premises, personnel or equipment actually possessed by the entity (e.g. whether the entity's personnel resources are adequate to the entity's role or to the scale of its business for instance it would be impossible for only one person to be an efficient decision-maker in the management of several companies engaged in business activities);
- d. the agreements entered into by the entity are economically genuine, have an economic justification and are not obviously in conflict with the general economic interests of that entity;
- e. the entity performs its core economic functions independently and using its own resources, including managers available on the premises of the entity.

The biggest uncertainty when interpreting the guidelines concerns the nature of holding companies. According to the Explanatory Notes, the fact that a holding company has one or two employees, or that their qualifications are insufficient, or their salaries are inadequate to

Although some of the amended provisions will not become effective before 30 January 2020, since 1 January 2019 withholding tax remitters have been required to exercise the due care if they aim to apply preferential withholding tax treatment.





their work duties, or the fact that the company has no permanent access to premises, equipment and software necessary for its decision-making, may result in that holding company not being considered by Polish law as having sufficient business substance.

The criteria for considering that a company actually conducts a business activity should be different for manufactures, trading companies or service suppliers and different for companies engaged in the broadly defined area of financial activities (e.g. investing or holding activities). As a result, the guidance for holding companies should certainly be made more precise in that regard, as the activities of such companies are, in principle, very limited.

In conclusion, a conduction of an actual business activity of a contractor within their country should be analysed in detail if a preferential withholding tax treatment is applied as lack of an actual business activities of that contractor may result in this contractor not being considered as a beneficial owner of the payment. Nevertheless, even if the conduction of the actual business activity requirement is met, it does not automatically mean that the contractor will meet the definition of beneficial owner, as they have to meet all the other requirements that are currently in place to be considered as beneficial owner.



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# Mergers: tax neutrality no longer so certain

**If you are planning to merge two companies, be careful! Until recently, tax neutrality for most mergers was clear and certain, and a merger was tax neutral if there were business reasons for it. However, following a change to the Corporate Income Tax Act, effective from 1 January 2018, a merger may, in certain situations, be taxable.**







## The law as it stands

According to the amended provisions of the Corporate Income Tax Act, the taxable revenue is the value, determined as at the date of the merger, of the acquiree's assets received by the acquirer or the newly formed company (s.12(1)(8c) of the Corporate Income Tax Act). However, the following is excluded from the taxable revenue:

- a. that value of the acquiree's assets received by the acquirer which corresponds to the issue price of the shares allotted to the shareholders in the merging companies (s.12(4)(3e) of the Corporate Income Tax Act);
- b. that value of the acquiree's assets which corresponds to the acquirer's percentage of the acquiree's share capital where this percentage is determined as at the last day preceding the date of the merger, if the assets are received by an acquirer holding at least 10% of the acquiree's share capital (s.12(4)(3f) of the Corporate Income Tax Act).

Furthermore, what is important for shareholders of the acquiree is that the taxable revenue in the case of a merger will not include the revenue earned by the shareholders in the acquiree or, as the case may be, the de-merged company, to the extent

that such revenue is equal to the issue price of the shares allotted by the acquirer or the newly formed company (s.12(4)(12) of the Corporate Income Tax Act).

Note that the above exclusions will not apply if the merger was completed other than for "valid economic reasons".

According to the justification to the amendment to the Corporate Income Tax Act, the proposed changes to the tax provisions governing mergers were not intended to be revolutionary. On the contrary, the intention was to make the new provisions an equivalent of the previous rules. However, on closer inspection, no such conclusion can be drawn from either the wording of the new provisions or the individual tax rulings issued based on them.

The first major change is the rule that the amount of revenue for the acquirer must be determined first, and then this amount may be reduced by (1) the issue price of the shares in the acquirer allotted as part of the merger and (2) the amount being the product of the acquirer's percentage of shares in the share capital of the acquiree multiplied by the value of the acquiree's assets. Although the new provisions say nothing about the value based on which the acquiree's revenue should be calculated, the practice established in individual tax

rulings is that the calculation should be based on the market value of the acquiree's assets.

## What is the issue price of a share?

A new term in the amended provisions is the issue price of a share. The Corporate Income Tax Act defines this term as the price for which a share is taken and which is specified in the company's statute or its articles of association or, if these documents are not available, in any other similar document, and which is not lower than the market value of the share (s.4a(16a) of the Corporate Income Tax Act).

The prevailing view in individual tax rulings is that the issue price of shares is the price "paid" to the acquirer for shares in the capital of the acquirer, i.e. the market value of the acquiree's assets. However, according to some commentaries on the new provisions, the issue price should be defined as the price which the acquirer or the newly formed company pays to any shareholder in the acquiree for the acquiree's assets. On the practical side, this would mean that the issue price should be equal to the market value of the shares in the acquirer or the newly formed company in return for the acquiree's assets.

It seems that the 'issue price' concept was introduced in the Corporate Income Tax Act as a way to prevent



Individual tax rulings disagree on whether a downstream merger completed without an increase in the subsidiary's share capital, i.e. without new shares being issued, may be a tax neutral transaction.





non-taxable transfers of assets between shareholders in merging companies, i.e. to ensure that the share exchange ratio in a merger is based on the market value of the assets of the merging companies. However, given the doubts about the interpretation of the new provisions, it is not clear whether (a) the exclusion from revenue under s.12(4)(3e) of the Corporate Income Tax Act will apply if the share exchange ratio is based on market values or (b) it is also necessary for the value of the increase in the acquirer's share capital to be determined on the basis of market values. My opinion is that this approach would be unfounded, as the result would be that a merger accounted for using the pooling-of-interests method could be taxable (where the exclusion under s.12(4)(3f) of the Corporation Tax Act does not apply fully).

### **A problem with downstream mergers**

Special attention should be given to what is known as downstream mergers, i.e. the acquisition of the parent company by a subsidiary. In such a case, the subsidiary buys back its shares from the parent company and then redeems the shares or issues them to a shareholder in the acquiree. As a result, such a merger may be completed with or without increasing the acquirer's share capital.

Individual tax rulings disagree on whether a downstream merger completed without an increase in the subsidiary's share capital, i.e. without new shares being issued, may be a tax neutral transaction. For example, in his interpretation of 15 November 2019 (reference: 0111-KDIB2-3.4010.275.2019.2.HK), the Director of the National Tax Information agrees with the applicant that the taking of shares, which is referred to in the definition of issue price, should be interpreted to mean not only the taking of newly issued shares as a result of a share capital increase, but also the situation where the acquirer issues any shares it has acquired as a result of the merger. This means that the exclusion under s.12(4)(3e) of the Corporate Income

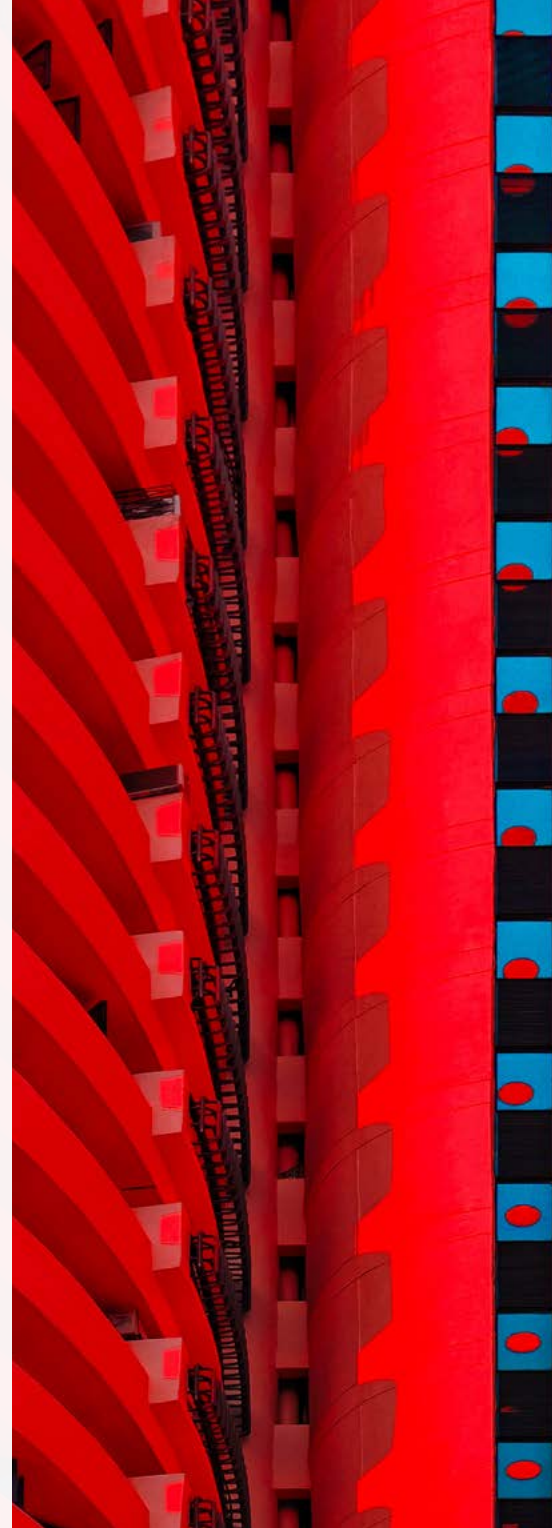
Tax Act may apply under such circumstances.

In another interpretation of 3 July 2019 (reference: 0114-KDIP2-2.4010.163.2019.1.AM), the Director of the National Tax Information states that the revenue exclusion under s.12(4)(3e) of the Corporation Tax Act applies where new shares are issued and allotted to the shareholders in the merging companies. This should not be equated with the allotment of existing shares. This interpretation means that a downstream merger is a taxable transaction.

### **A conflict with an EU directive**

As the new provisions are unclear, if the merger is more complicated or if there are changes in the valuation of the merging companies, it may be impossible to ensure the tax neutrality of the transaction. In such cases, it is fair to say that the Polish regulations are in conflict with the EU directive concerning mergers (Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States).

To recap, today more than ever before, taxable persons should take care to verify whether a particular merger may enjoy the benefits of tax neutrality and, if they have any doubts, should apply for an individual tax ruling.

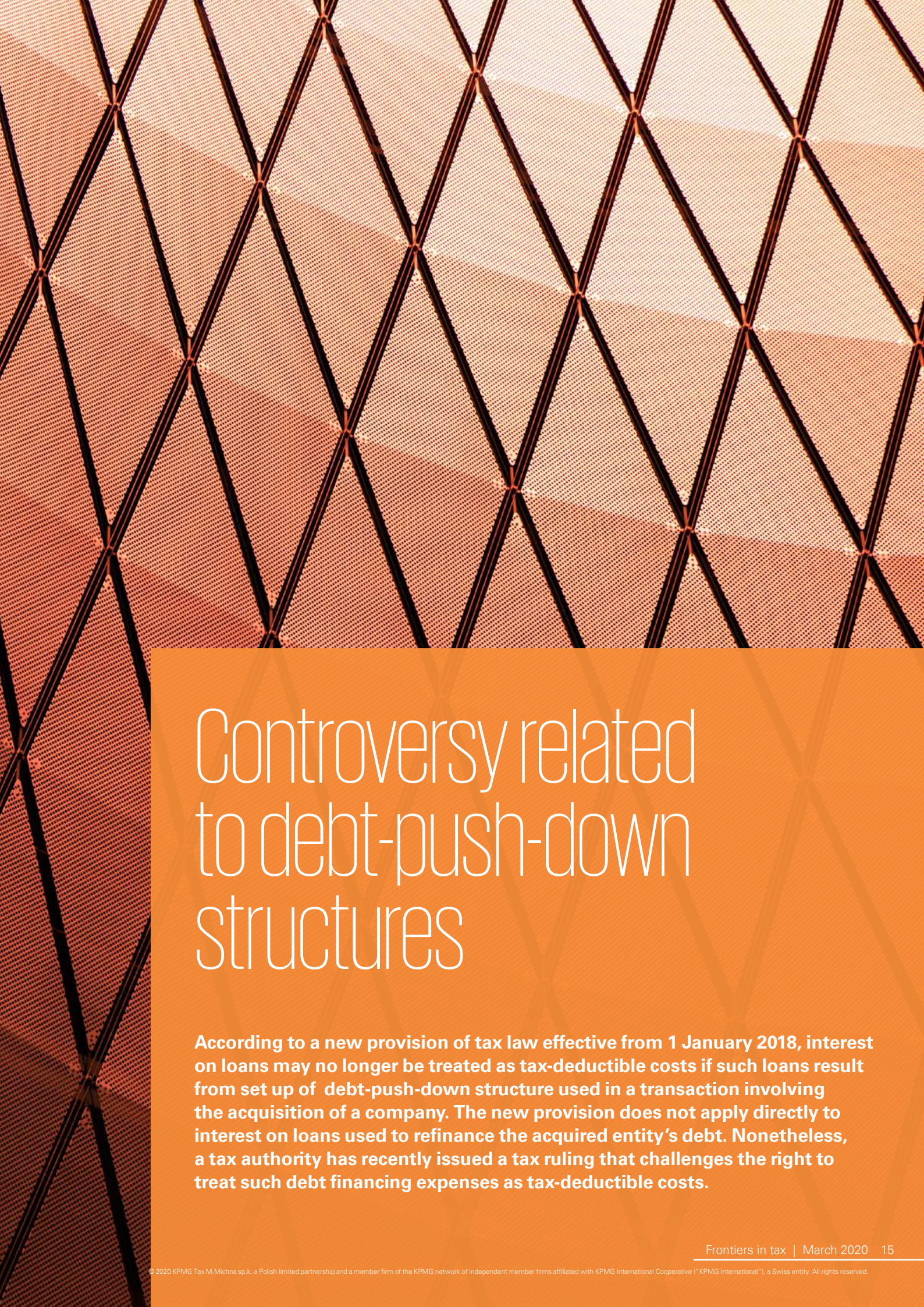


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# Controversy related to debt-push-down structures

**According to a new provision of tax law effective from 1 January 2018, interest on loans may no longer be treated as tax-deductible costs if such loans result from set up of debt-push-down structure used in a transaction involving the acquisition of a company. The new provision does not apply directly to interest on loans used to refinance the acquired entity's debt. Nonetheless, a tax authority has recently issued a tax ruling that challenges the right to treat such debt financing expenses as tax-deductible costs.**



## Limitation of tax benefits resulting from debt-push-down structure

Until the end of 2017, it was a common practice to use so-called a debt-push-down structure in restructuring processes. The structure typically involved setting up a special purpose vehicle (SPV) which received a loan that was used to acquire directly shares in another company. The newly acquired company was then merged with the SPV (i.e. with the company's shareholder). The tax benefit of this restructuring process was that the acquired entity's operating income could be reduced by the interest on the financing used for acquisition of shares in this entity.

After 1 January 2018, the provisions of the Corporation Tax Act prevent to use of the tax benefits resulting from debt-push-down structures under article 16(1)(13e) of the Corporation Tax Act. The provision expressly provides that taxpayers cannot treat the costs of debt used to finance the acquisition of shares in companies as tax-deductible costs, to the extent that such costs would reduce the tax base that includes revenue from that company's business activities, particularly in the case of mergers, in-kind contributions, conversions to

a different legal form or the formation of a tax capital group.

It is worth noting that the limitation provided for in article 16(1)(13e) of the Corporation Tax Act applies only to the costs of debt borrowed to pay for shares in an acquired company to be merged with the borrowing company. This provision does not apply to the costs of debt obtained for any other purposes, such as refinancing the acquired company's debt incurred in the course of its business.

## Additional limitations on tax-deductible expenses related to mergers

The right to treat as tax deductible the costs of debt obtained to refinance an acquired company debt if it is subsequently merged with a company being its shareholder was the subject of analysis in an official tax ruling issued by the Head of the National Revenue Information of 29 March 2019 (reference: 0111-KDIB1-3.4010.46.2019.1.MBD). The doubts concern whether the taxpayer was allowed to recognise as tax-deductible costs the interest paid by the acquiring company to its shareholder on debt obtained to refinance the acquired entity's debt.

The tax authority stated that although interest on debt obtained to refinance the debt of a acquired company which then was merged with its shareholder is not covered by the restriction provided for in article 16(1)(13e) of the Corporation Tax Act, such interest may not be treated as a tax-deductible costs according to the general tax rules, because it is not paid by the SPV to earn revenue or to retain or secure source of the revenue. The tax authority's argument to support its standpoint was that interest used to finance the activities of an acquired entity is not connected with the activities of the acquiring company, because such interest is related to the repayment of the debt of another company. The authority also notes that the acquiring entity was aware that it would not earn any revenue, e.g. interest received, because the acquiring entity's intention was to merge with the acquired company. The taxpayer appealed against the tax ruling obtained to the Voivodship Administrative Court in Warsaw.

In its judgment of 12 December 2019 (Case No.: III SA/Wa 1374/19), the Voivodship Administrative Court in Warsaw disagreed with the tax authority and confirmed that the costs of debt borrowed to refinance an acquired entity's debt might be treated as the tax-deductible cost after the merger. The court has found that as a result of the merger, debt borrowed by the acquiring company is replaced with debt from the acquiring entity's shareholder, which does not mean that the interest on the refinancing debt is no longer connected with the acquired company's business. The judgment is not legally binding yet.

## Implications for taxable persons

Under the universal succession in mergers, the tax ruling issued by the tax authority seems highly controversial. As a result of the merger, the acquiring entity continues the acquired company's operations and, therefore, the acquired entity's revenue becomes the acquiring company's revenue. Consequently, the loan replacing the debt obtained to finance the operation of the acquired

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It is worth noting that the limitation provided for in article 16(1)(13e) of the Corporation Tax Act applies only to the costs of debt borrowed to pay for shares in an acquired company to be merged with the borrowing company.

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entity is connected with the taxpayer revenue. Therefore, it is unjustified to assume that as a result of the merger, the interest on the loan used for debt refinancing does not meet the criteria for treating such interest as tax-deductible costs. We strongly agree with the verdict of the Voivodship Administrative Court in Warsaw issued in this respect.

#### **Other limitations on the treatment of debt financing costs as tax deductible**

Although the tax benefits of debt-push-down structures are expressly restricted in provision 16(1)(13e) of the Corporation Tax Act, it is important to take note of some other limitations on the treatment of debt financing costs as tax-deductible expenses, such as earning stripping rules (provided for in article 15c of the Corporation Tax Act), which also apply to debt for financing purposes received from unrelated parties; the division of revenue into

capital and operating ones, which prevents the setting-off of the cost of interest paid resulting from loan for shares acquisition in another company against operating income; or restrictions imposed by transfer pricing regulations.

In addition, in the case of any restructuring transaction that involves a merger, the applicability of general anti-avoidance rules (GAAR) and/or specific anti-avoidance rules (SAAR) should be also taken into consideration.



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# Warranties and indemnities in share purchase agreements

A key document in transactional practice is the share purchase agreement (or SPA). This document contains provisions governing, among other things, the terms of the transaction, the payment of the price as well as financial settlements between the parties, their obligations and responsibilities. It is the primary document negotiated between the parties to cover tax matters. In recent years, particularly in transactions involving certain countries, SPAs are accompanied by tax deeds. A tax deed is a separate document dealing with the tax matters agreed upon between the purchaser and the seller.







From the purchaser's perspective, the purpose of both documents is to provide for the situation where the company is purchased and, subsequently, it turns out that its tax treatments prior to the transactions were incorrect. If this happens, the company may be liable for underpaid tax, interest (which can be high, particularly if a tax inspection reveals tax treatment mistakes made a few years prior) or even additional penalties.

To ensure the best possible protection for itself against existing or past tax arrears of the acquired company arisen before the acquisition, the purchaser will normally try to obtain certain warranties and/or indemnities from the seller as regards tax matters.

#### **Seller's warranties**

The purpose of the warranties given and the representations made by the seller is to ensure that, generally speaking, the company has complied with its tax obligations in accordance with the applicable regulations. In theory, it may seem that to have a claim against the seller it will be sufficient for the purchaser to prove that the seller is in breach of the general warranty that the company calculated and paid taxes as required by tax regulations. In practice, however, such a claim will be possible if the purchaser obtains specific warranties as precise as possible and reflecting the nature of the acquired company's business and the information obtained by the purchaser in the transaction process, including during discussions with the seller and from the due diligence (if conducted). As a result, such warranties should address, depending on the situation, general matters (e.g. correct bookkeeping, compliance with deadlines for paying taxes and filing tax returns), but also more specific issues, covering correct tax treatments of sensitive transactions (e.g. correct application of reduced VAT rates, withholding tax), the preparation of complete transfer pricing documentation or the maintenance of all the documents required to claim the 0% tax rate in

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Both the indemnity clause and the seller's warranties are time-limited and should last no longer than until the expiry of the company's tax liabilities.

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the case of export transactions or intra-Community supplies of goods.

What is important to ensure a successful potential claim is that the seller's warranties given to the purchaser should not be based on subjective factors, i.e. the seller's knowledge, its familiarity with the applicable regulations or its awareness of certain circumstances. Examples of expressions used to weaken the strength of warranties include "to the best of the seller's

/ the company's management's knowledge" or "the seller is not aware".

#### **Indemnity clauses**

An alternative method of protecting the purchaser's interests is the so-called indemnity clause, which will normally be used in a share purchase agreement if the due diligence examination reveals any irregularities regarding the company's tax treatments. It is less burdensome for the purchaser to pursue claims against the seller under an agreement with such a clause than it is on the basis of warranties. In the case of a claim based on a warranty, the purchaser will have to prove the seller's breach of the warranty and that the purchaser did not know of the breach and suffered damage as a result of the breach. In such a case, the success of the claim may depend on the construction of specific provisions of the share purchase agreement.

If the share purchase agreement contains an indemnity clause, the occurrence of a specified event resulting in the seller's liability will be a sufficient basis for the purchaser's claim. Such events may include, for example, the issue of a decision to assess the amount of underpaid tax and the related obligation to pay the tax, without the purchaser having to prove any other circumstances of the event.

Given the nature of the indemnity clause and the fact that the benefits for the indemnified party are considerable, the use of the clause is limited to cases precisely specified in the share purchase agreement, i.e. the occurrence of which stems from the events indicated and relates to taxes specified in the agreement, with the purchaser's maximum liability under the clause strictly limited to a specified amount (if the parties have agreed upon such an amount) in respect of one event and/or all the specified events jointly.

Both the indemnity clause and the seller's warranties are time-limited and should last no longer than until the expiry of the company's tax liabilities.





## Tax deed

At this point, it is worth noting the increasingly popular and important additional agreements that more and more frequently accompany share purchase agreements, i.e. tax deeds, already mentioned at the beginning of this article. A tax deed is a separate document signed by both parties together with the SPA. This document originated in English law and is a very practical instrument used by the parties to a transaction to provide for the steps to be taken in the event of the occurrence of certain circumstances specified in it and related to tax matters. Given the fact that tax matters are currently a highly sensitive aspect of transactions due to significant changes to legislation and the practices of tax authorities, a tax deed will usually provide that the seller is fully liable for the company's tax arrears relating to the period before the closing date of the transaction.

A tax deed provides for situations where the seller's liability for the company's underpaid tax may be triggered, e.g. in the case of a tax inspection at the company which covers certain taxes or tax issues, or the assessment, by a tax authority, of the amount of underpaid tax, or a tax authority's refusal to make a refund of VAT to the company, etc. If an SPA is accompanied by a tax deed, then if a specified event occurs, the document will clearly state how to deal with it and how the parties should work together if a tax dispute with the tax authority arises, e.g. which of the parties will manage the dispute. Other matters agreed in a tax deed may include keeping the other party informed of the status of any matter that may affect their financial settlements connected with tax-related warranties, or provisions for incurring and accounting for the costs of such matters, or making decisions about formal appeals. In addition, the parties may decide to include an indemnity clause in a tax deed rather than the related SPA.

Given the pace of amendments introduced to both Polish and international legislation, the

changing decisions of the courts and inconsistencies in tax authority decisions, appropriate warranties and indemnity clauses covering the company's tax settlements should be among the purchaser's priorities when negotiating the terms of the SPA. Tax underpayments are real money and may seriously affect the profitability of the purchaser's investment. It is, therefore, advisable to include appropriate safeguards in share purchase agreements.



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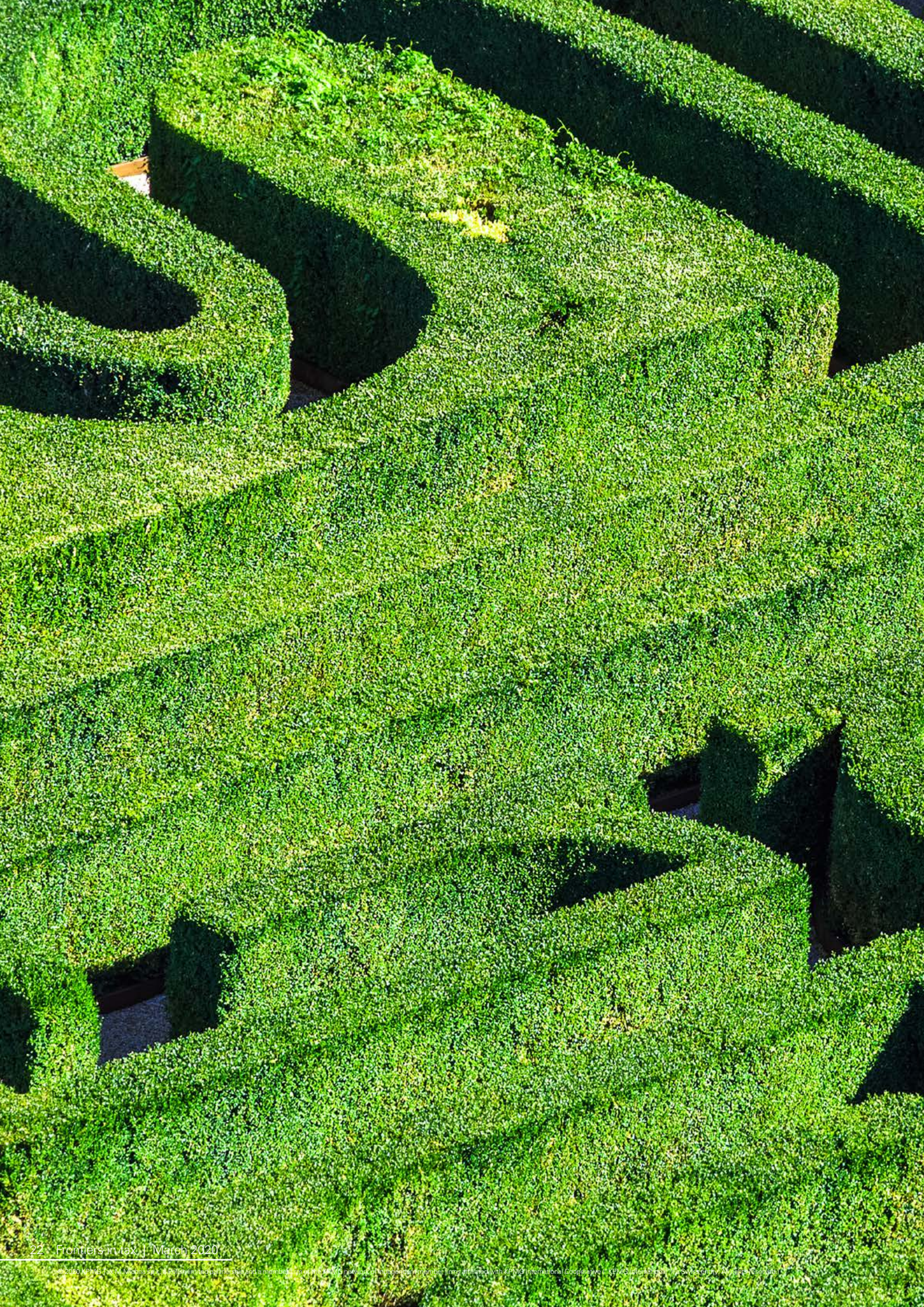
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An aerial photograph of a lush green hedge maze, showing complex, winding paths and sharp turns. The hedges are well-maintained and vibrant green, set against a dark, shadowed ground. The perspective is from directly above, looking down into the maze.

# Tax aspects of price adjustments in M&A transactions

**Depending on the transaction subject, M&A transactions may involve either the sale of shares (known as share deals) or the transfer of specific assets individually or as an operating business (referred to as asset deals or business deals, respectively). As these two types of transaction differ, the tax aspects of adjustments to the purchase/sale price will also vary.**



The matter of correct tax treatment of the purchase price in M&A transactions is one of the most complex issue and, as such, requires cooperation between the parties to the transaction in the legal, financial and tax aspects. Matters to be looked into may include the nature of the transaction in terms of its subject matter, or the mechanism of tax treatment of the purchase price, the time at which the value of the transaction is fixed, or the agreed price adjustments.

### Price adjustments in share deals

As regards share deals, price adjustments causing tax implications may occur even at the level of a due diligence examination. Firstly, when conducting the due diligence examination and identifying a number of tax risks, the purchaser may consider using an indemnity clause as a safeguard against the identified risks, (for a detailed discussion of indemnity clauses, see the Warranties and indemnities in share purchase agreements article) or the mechanism whereby the payment of the price is deferred and transferred to and held in an escrow account until the conditions for releasing this part of the price are met, or adjustment of the price to reflect the value of the identified risks. In the case of the price adjustment alternative, what is important is the value of the tax risk(s), but also, and perhaps most importantly, the likelihood of the potential risk materialising. This option is obviously not so advantageous for the seller, as the sale price is reduced. However, it allows the seller to eliminate, in

advance, the risk of disputes and payments under indemnity clauses. The choice of safeguards against tax risks will depend on the type of transaction and the parties involved. Price adjustment is usually the preferred option if one of the parties is an investment fund, e.g. a private equity fund or a venture capital fund, interested in total divestment.

Another important issue on the tax side is to address elements that may affect tax liabilities later due to the differences in their treatment for accounting and tax purposes (deferred tax), e.g. amortisation/depreciation, accrued interest or unrealised foreign exchange differences. Often so called "tax assets" including for example tax losses settled within a given source, or interest expenses that were not settled within the earnings stripping limit remain the key aspect of it. Whether and to what extent such items can be utilised by the purchaser in the future may also affect the valuation of the company for tax purposes.

In share deals, price adjustments may also depend on the moment at which the transaction price is set. Within this context, the mechanism included in the share purchase agreement will be crucial and will determine whether

- the price will be fixed as at a specific date in the past (known as the locked box mechanism) or
- the price will initially be fixed before the share purchase agreement is signed, based on the expected price on the date of the transaction; this initial price

is later reviewed by reference to the actual figures (this is known as the completion accounts mechanism).

Potential adjustments either reducing or increasing the price, may be used in the case of the second mechanism. Correct determination of the final price under the completion accounts mechanism requires the calculation of the final price by one party to the transaction and verification of the data by the other party to the transaction from the accounting and tax perspective (based on the procedures specified in the share purchase agreement). From the tax perspective, in addition to ensuring that the final price is based on correct balances of liabilities, it is necessary to consider the tax implications of such an adjustment. The main problems to consider include the effect of the adjustment on the tax base for the purpose of the tax on civil-law transactions, as well as the tax point and method of recognising the adjustment for corporate tax purposes. As regards the tax on civil-law transactions, under current practice an adjustment should not affect the tax base, as the tax base is the market value set as at the transaction date, i.e. a date before the adjustment date. Regarding the corporate tax aspect, such an adjustment should generally be an element affecting the shares price in the transaction.

On the practical side, the materialisation of a specific risk which will trigger the indemnity mechanism of the purchase agreement, may also be problematic. More specifically,



The structure of the transaction according to the objectives and expectations of the parties will determine the type of price adjustments that may arise.







a situation where the purchaser will rely on the provisions of the share purchase agreement once shares in a company have been transferred, as the basis for a compensation claim, e.g. within the framework of contractually secured risks and how the receipt of a compensation by the purchaser or a company (in which the tax risk has materialised) should be included for tax purposes.

A totally different type of adjustment of the sale/purchase price is adjustment resulting from additional payments for shares, depending on the satisfaction of certain conditions set out in the share purchase agreement. From the purchaser's perspective a problem may arise on how to recognise such payments for corporate tax and tax on civil-law transactions purposes. In both cases, the recognition of such a payment will depend on the legal title to the payment, which will be set out in the share purchase agreement.

### Price adjustments in asset deals

Given the issue of liability of the purchaser and the fact that it is impossible to transfer tax attributes, such as tax losses, the approach to price adjustment will be different in asset and business deals. Tax adjustments for price-fixing purposes will not be as important in the course of an asset and business deal as they will be in case of a share deal. They may, however, be important when the price paid for the assets (or

a business) is to be settled in line with the mechanisms included, within the sale and purchase agreement, and may include elements that will depend on the results generated by the business over a particular period of time, e.g. as part of the earn-out clause.

Within this context, the following doubts may arise from the tax perspective: Whether such an adjustment affects the goodwill? How should such an adjustment be treated for corporate tax purposes, i.e. as the price part or as a cost/revenue item recognised in the period in which the adjustment was made? Or should the adjustment be treated as part of the price for VAT or civil-law transaction tax purposes? The contractually agreed legal titles to any such additional payment will determine the recognition of the payment. Normally, the sale and purchase agreement will provide for different legal titles to specific additional payments to ensure that the payments do not affect any previous settlements between the parties.

### Conclusion

The structure of the transaction according to the objectives and expectations of the parties will determine the type of price adjustments that may arise. As these matters are normally decided at the negotiation table and, finally, in the sale and purchase agreement, price adjustments can be identified in

a right way only if the accounting, tax and legal issues are reviewed correctly. A certain flexibility of shaping such adjustments may have different implications on the tax side for different types of adjustment. Therefore, it is crucial to consider the tax aspects of any transaction, not only in terms of legal compliance but also on the financial side, as early as in the negotiation process for both share deals and asset deals.



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# MDRs and M&As: the moment of reporting a tax scheme

**For any M&A transaction completed on or after 1 June 2018, an analysis conducted by the parties should cover the potential obligation to report the transaction as a tax scheme. Mandatory Disclosure Rules (MDRs), which apply in such cases, are the result of Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements ("DAC6 Directive").**



In Polish law, MDRs have been effective since 1 January 2019 and apply to events implemented after 26 June 2018 (for cross-border schemes) or after 1 November 2018 (for all other schemes). Currently, Poland is still the only country with MDRs based on the DAC6 Directive. It is also a country where penalties for non-compliance with MDRs are the highest, with the upper limit amounting to approx. PLN 25 million. These penalties are provided for in the Polish Fiscal Penal Code and apply to private individuals. Note, however, that non-compliance with procedural requirements may result in an administrative penalty of up to PLN 10 million.

MDRs were implemented into Poland's national legislation very early and, in January 2019, extensive explanatory notes were issued ("MDR Explanatory Notes"). However, as Polish tax administration authorities will not, contrary to earlier declarations, accept applications for individual tax interpretations covering MDRs and will only assign tax scheme numbers, practical guidelines on the application of MDRs are very limited. Given the risk of severe penalties for non-compliance, this may be a reason for concern, particularly in the case of large projects, such as M&A transactions.

As the MDR subject is a broad one, this article will only mention certain problems causing uncertainty in M&A transactions.

### **Deadlines for reporting M&A transactions**

It is no secret that M&A transactions can be highly complex.

The transaction process will often be split into a number of phases, each following a different route, but all of them leading to the same goal, i.e. the purchase of an asset (a company or real property). While the initial stages of the process may be handled internally by the investor, the later stages may involve the use of different advisors, be they tax or legal consultants, or commercial advisers, or simply intermediaries hired to manage the transaction process. A bank or an insurance company may come into

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An arrangement is defined as a factual act, a legal act, or a combination of both. In transactional practice, both parties enter into the same agreement (thus performing the same legal act), while each party separately will perform several other acts on its part.

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play, and various documents will have to be signed with them. However, the investor and the seller (and their advisers) will continue to exchange proposals, enter into agreements and negotiate contractual provisions. Additionally, each party involved in the transaction will continue its own preparations, which may include designing the structure of the purchase or sale, or working on financing arrangements. An M&A transaction is such a complicated process that it may be difficult to determine the time when the statutory time limit for reporting the transaction begins. This difficulty is caused by the use, in statutory provisions, of language such as "making available", "being prepared for implementation" or "the first implementation act".

The "making available" requirement is rather unlikely to be met if the solution (an investment or an arrangement) was developed internally by the investor, in which case no tax scheme is made available to anyone. However, things become complicated if the investor's group of companies includes persons working as advisers to other companies (i.e. people responsible for different areas of the investment process, known as the investment committee).

### **The scope of an arrangement**

Another area of uncertainty for the parties to M&A transactions is the determination of the scope of an arrangement that may potentially become a reportable tax scheme. This is an important issue, as it affects the presentation of the companies involved in the transaction, as well as the scope of an analysis to determine whether the arrangement shows any hallmarks.

An arrangement is defined as a factual act, a legal act, or a combination of both. In transactional practice, both parties enter into the same agreement (thus performing the same legal act), while each party separately will perform several other acts on its part. It is, therefore, not clear whether a particular transaction should be regarded as a single arrangement or at least two separate arrangements. The practical implications of both approaches are definitely serious. More specifically, if





a transaction is regarded as a single, integrated arrangement, then it is necessary to check if the other side of the transaction involves a promoter or any other beneficiary of the scheme. Moreover, if the arrangement is reported as a scheme, the required information will, under s.87f, have to be provided to all the entities with a reporting obligation, and this includes the other party to the transaction. Such information may include plenty of sensitive and/or confidential information that one of the parties may not want to disclose to the other party. However, the failure to make the disclosure may result in a penalty under the Polish Fiscal Penal Code.

### Hallmarks

There is also some uncertainty when verifying the presence of hallmarks. It may be particularly difficult in the case of the hallmarks set out in the Polish regulations, namely 'other specific hallmarks'. They are so unique that they are totally different from the standard hallmarks set out in the MDR Directive. The Polish regulations have adopted a financial approach, which may be problematic when making the required calculation. It is not clear what should be the basis for calculating the future income (revenue) resulting from the arrangement. Will this require dedicated forecasts? What steps should be taken if, after implementing an arrangement where, for example, the cash flows from a taxpayer that is not a resident for tax purposes are not higher than PLN 25 million (because, for example, the expected amount was PLN 20 million), the actual cash flows from the arrangement are higher?

As regards other hallmarks, those set out in the MDR Directive are not much better than the Polish ones. An

M&A transaction may find it difficult to meet the definition of a typical tax scheme based on the Directive hallmarks. One example of a specific hallmark under the Directive may be the transfer of functions and/or risks and/or assets between related parties (in a way that affects the EBIT). Taxpayers wonder whether this hallmark should be regarded as satisfied in the case of a merger (where the acquirer takes over the acquiree's functions and/or risks and/or assets). Another specific hallmark that may cause uncertainty as regards M&A transactions is one that identifies tax schemes on the basis of a transfer of intangible assets. It is difficult to determine what can be considered as an intangible asset and to what extent such asset is to be transferred, and to what degree it will determine the value of the transferred group of assets (e.g. whether this hallmark will be satisfied if what is transferred is an entire business with an identified customer database).

### The direction in the MDR regulations

The complexity of any M&A transaction means that a detailed analysis is required to identify the events that may result in the obligation to report the transaction as a tax scheme to the Polish National Tax Administration Service. A transaction may, after all, involve some advisers or consultants, where the time limit for reporting begins regardless of when a tax scheme is made available or implemented, but when their advice is given. In transactional practice, given the duration of transactional processes, it may be necessary to report a tax scheme long before it is created.

As a result of the fast pace of implementing the MDR Directive into Polish legislation, without a prior,

comprehensive consultation process, many practical questions are asked. The MDR Forum at the Polish Ministry of Finance may give some hope. Its role is to analyse the relevant regulations and MDR Explanatory Notes and to recommend changes to businesses and their advisers or consultants.

On 27 January, the Government Legislation Centre published, on its website, a Bill to amend the Tax Law Act, among other regulations. The Bill was discussed by the lower house of Parliament on 5 February and subsequently amended. If it becomes law, all promoters and beneficiaries who have already reported a cross-border tax scheme between July 2018 and March 2020 will be required to do it again. The reason is that the electronic report format (known as schema), adopted hastily, turned out to be inconsistent with the EU format, and because the changes are considerable, the Polish tax administration service is unable to make them on its own. As a result, the amended Bill requires taxpayers to help make the changes. Once again, no public consultations were held, and no information was provided to the MDR Forum.



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# The implications of Brexit and tax aspects of mergers and acquisitions

**On 1 February 2020, after months of discussions, the UK left the European Union. This means that the transition period and the terms of trade between the European Union and the UK will remain unchanged until the end of 2020. In particular, European directives will continue to apply to the UK until then.**



Now that the UK is a third country in relations with the European Union, all EU directives will cease to apply to the UK as of 1 January 2021. The terms of trade when the transition period ends will depend on the terms of the future free trade agreement, but its provisions are yet unknown. Negotiations of the agreement should begin in February 2020. From the tax perspective, particularly in the case of transactions, the critical point will be whether or not the UK will be a member of the European Economic Area (EEA), which does not seem very likely at the moment.

### Withholding tax

As regards income tax, if the UK is not a member of the EEA, the provisions implementing EU directives under which dividend payments, royalty payments and interest payments are now exempt from withholding tax will cease to apply on 1 January 2021.

Such payments when received in an EU member state (e.g. Poland) by a company established in another EU member state (e.g. the UK) may be liable to income tax in the source member state in accordance with the local tax regulations. However, if certain conditions set out in the relevant directives are met, it may be possible to avoid paying withholding tax on revenue.

In addition, it is possible to reduce or avoid paying withholding tax under a tax treaty.

As a result of leaving the EU, the UK has lost its EU member state status as well as the right to apply the provisions of EU directives as the basis for reducing withholding tax burdens within the EU. If the UK is not an EEA member, there will be no basis for Polish companies making dividend, interest or royalty payments to UK-based companies to apply such provisions to enjoy withholding tax exemptions. Polish taxable persons will only be able to apply the reduced rates now available in the tax treaty between Poland and the UK, if the relevant requirements are met, including the requirement of

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Brexit is likely to have a negative impact on the tax treatment of certain restructuring activities involving UK-registered companies in Poland. An important point in the case of such activities is whether the UK will be an EEA member, which is not very likely, as was mentioned above.

due diligence and the possession of the required tax residence certificate.

As regards dividend payments, things should remain unchanged. The tax treaty provides for an exemption from withholding tax if the beneficiary has held at least 10% of the company's shares for two years. In all other cases, a 10% rate of withholding tax will apply.

For interest and royalty payments, the tax treaty provides for a 5% tax rate (or 0% in exceptional situations, such as in the case of interest on bank loans). This will adversely affect the cash flows that benefit from the exemption under the tax treaty now.

Given the possible negative changes to withholding tax rules, this is the last moment to look at the present structures of international groups of companies. What is particularly important within this context is to verify such structures in terms of intragroup financing as well as the location of strategic intangible assets. As regards withholding tax on dividend payments, no revolutionary changes should be expected, as the

provisions of the tax treaty between Poland and the UK are advantageous. However, the applicable requirements must be met, otherwise the exemption from corporation tax at 19% on dividend payments received by the Polish company cannot be claimed.

### Restructuring transactions involving UK companies

Brexit is likely to have a negative impact on the tax treatment of certain restructuring activities involving UK-registered companies in Poland. An important point in the case of such activities is whether the UK will be an EEA member, which is not very likely, as was mentioned above.

Certain restructuring activities are tax neutral in the EU when they are completed, and the payment of any tax is deferred until the capital gains on the assets transferred are realised. This is regulated in the EU directive on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different



Member States and to the transfer of the registered office of an SE or SCE between Member States.

When the transition period ends, none of the restructuring transactions specified in the Corporation Tax Act (i.e. merger, division, in-kind contribution of a business) whereby a UK-registered company acquires the assets of a Polish taxable person liable to pay corporation tax or transfers its own assets to a Polish company (to the extent permitted by law), will be able to enjoy the benefits of tax neutrality under the Polish Corporation Tax Act (even if any other statutory requirements are satisfied). In such a case, the Polish taxable person will be eligible to apply the provisions of Poland's tax treaty with the UK to the extent that treaty protection is available.



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# KPMG Publications

**The KPMG analyses and reports are an output of our expertise and experience. The publications take up issues important to enterprises operating in Poland and globally.**



## **The luxury goods market in Poland. Luxury for generations**

This report is the tenth, jubilee edition of KPMG's publication on Poland's luxury industry. For the purpose of this report, a "luxury good" means any good marketed under a brand commonly recognised to be a luxury brand on a particular market or a good that has been given a luxury feel by what makes it stand out (e.g. its uniqueness or high price). The analysis is supplemented with comments from experts specialising in the segments covered by this report. The survey on the perception of luxury goods in Poland was conducted in October 2019, by engaging a representative sample of 1,549 respondents.



## **The fashion market in Poland. The challenges**

This report is based on a survey conducted in October 2019 with a national sample of the Polish population represented by 1,174 adult men and women from the X, Y, and Z generations and living in Poland's ten largest cities. The main theme of the report is the challenges facing the fashion industry. These include differences in attitudes to fashion between the different generations, as well as their shopping preferences and the effect of eco-trends on the industry, plus consumer attitudes.



## **The automotive industry, Q4 2019**

This report is one in a series of quarterly reports that look at the current trends in Poland's automotive industry, defined to comprise the automotive market, industrial manufacturing and automotive financial services. This analysis is based on the latest available vehicle registration figures, other statistics and market data. The report is the result of joint work undertaken by the Polish Association of the Automotive Industry and KPMG in Poland.



## **Does the customer matter most? Of course! An analysis of customer experiences offered by banks in Poland**

This report looks at what Polish consumers think of their customer experiences related to using certain banking products (personal accounts, credit card accounts and mortgage loans) throughout the customer journey and at as many points of customer-bank contact as possible.



## **Property Lending Barometer 2019**

This report is based on answers from more than 70 financial institutions operating in the real estate sector. The purpose of this report is to assess the prospects and sentiment for bank financing in the European real estate sector based on the opinions of bank representatives from 15 countries. The survey was conducted between May and July 2019.



## **Employee Capital Plans (ECPs). The challenges for employers implementing ECPs**

This report, conducted in August 2019, is based on a Poland-wide survey. The survey used CATI methodology with a sample of 120 employers with at least 50 employees each and the largest organisations with more than 250 employees each. The purpose of the survey was to identify the challenges facing employers implementing employee capital plans.



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