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Prohibition on simultaneous deduction of costs, credits and losses in several countries

I. The provisions on hybrid structures make tax group settlements more difficult

At the beginning of 2021, the provisions of Chapter 3a of the CIT Act regulating the so-called hybrid structures entered into force. Their purpose is to prevent optimization with the use of hybrid structures, i.e. entities and events that are treated differently by different countries for tax purposes. The hybrid structures themselves should be understood as combinations of two or more basic organizational structures, aimed at tax optimization in countries where they are established. One of the consequences of the entry into force of those regulations is that now, when obtaining financing from entities of an international capital group, not only the company's own transactions but also the transactions of the group's parent entities must be analyzed.

II. Hybrid structures impose restrictions on the treatment of expenses as deductible

The treatment of a given arrangement as a hybrid structure results in restrictions in the area of recognition as deductible expenses (tax costs) of expenditures which, in accordance with the general definition of costs, might constitute such expenses, or an obligation to recognize taxable revenues on account of events that are normally entirely neutral under the CIT Act, such as e.g. accrual of interest. Concerned in the case of hybrid structures are primarily arrangements where the end result is recognition of one and the same cost in different tax jurisdictions without recognizing income in both countries (so-called double deduction), or recognition of a specific payment as an expense in the country of the entity making such payment but without taxation of the income on account of that payment in the country of its recipient (so-called deduction without taxation).

Currently, due to the provisions on hybrid structures in force from the beginning of 2021, when obtaining financing from entities of an international capital group, not only the company's own transactions but also the transactions of the group's parent entities must be analyzed.

III. The hybrid structure provisions introduced 21 new definitions

The CIT Act in its part regulating taxation of hybrid instruments contains an extensive glossary of terms used in those provisions (as many as 21 such terms have been defined). Explained are, among other things, terms such as: hybrid transaction, hybrid financial instrument or hybrid entity. Thus hybrid transaction should be understood as an arrangement on transfer of a financial instrument, where the same underlying income (revenue) from that instrument is treated for tax purposes as income (revenue) earned by more than one party to such arrangement. The hybrid financial instrument is a financial instrument that is qualified for tax purposes differently in the payer's country than in the recipient's country, as well as the hybrid transaction. Further, the hybrid entity is an entity that is treated as non-transparent for tax purposes in one country and as transparent for tax purposes in another country. The Act also defines market-based hybrid transactions, which are hybrid transactions entered into by market participants in the ordinary course of business rather than within a structured arrangement.

IV. The new provisions have introduced their own definition of related party

Two other important definitions in the area of hybrid structures are those of related party and structural arrangement. The definition of related party introduces the requirement of a shareholding of at least 50% (the standard requirement under other provisions being 25%) in the capital or voting rights in the supervisory, decision making or executive bodies of another entity, or the right to a share in the profit of such another entity. Further, a structural arrangement is a type of arrangement which, to simplify things (the actual definition is quite complicated in terms of linguistics), establishes a hybrid structure in order to take advantage of discrepancies in the qualification of entities or payments for tax optimization purposes. At the same time, the structural arrangement may also involve entities completely independent from each other, that is unrelated.

V. The same expenses cannot be deducted twice in two different countries

In the area of costs, the provisions first of all exclude the right to treat expenses subject to double deduction as tax-deductible. Thus the taxpayer is not entitled to recognize expenses that are subject to double deduction as tax-deductible if both of the following conditions are met. First, if the double deduction was made by related entities or within the framework of a structural arrangement. Second, if Poland is the country of the investor or the payer - if the investor's country other than Poland has not excluded the right to deduct such expenses. However, this provision does not apply if the double deduction corresponds to income (revenue) disclosed twice in the current or subsequent tax period both in the investor's and in the payer's country.

VI. Expenses cannot be recognized as deductible if revenues are not taxed

Expenses deductible without taxation are also excluded. The taxpayer is not entitled to recognize expenses that are subject to deduction without taxation as tax-deductible if all three of the following conditions are met. First, if the deduction without taxation occurred in any of the six cases listed in the CIT Act. The performances listed in those cases mean any titles providing the grounds for recognition of a given amount as a deductible cost, write-downs included. Second, if the deduction without taxation was made by related entities or within the framework of a structural arrangement. And third, if Poland is the payer's country.

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VII. Revenue associated with an expense must arise within a reasonable time

One of the six cases in which expenses subject to deduction without taxation are excluded from tax-deductible costs is the situation where the performance on account of a hybrid financial instrument, due to differences in the nature of that instrument or performance, does not give rise to income (revenue) in the recipient's country within a reasonable time. Here, a performance is deemed to give rise to income (revenue) within a reasonable period of time if such income (revenue) occurs within a period not exceeding 12 months from the end of the payer's tax year in which the performance was made, or can reasonably be expected to occur within another period that would apply were the performance made on the arm's length basis between parties other than related parties.

VIII. Also losses cannot be deducted from income or recognized as deductible twice

The hybrid structure provisions also exclude the right to recognize losses as tax-deductible expenses or to reduce the income (revenue) by losses. The provisions stipulate that the taxpayer is not entitled to recognize losses as tax-deductible expenses or to reduce its income (revenue) by losses if both of the following two conditions are met. First, if the costs or losses are deductible in at least two countries in which that taxpayer is treated as tax resident. Second, if the costs or losses do not correspond to income (revenue) reported twice. If the taxpayer is deemed to be a Polish tax resident of at least one other Member State of the European Union, this provision applies if the taxpayer has not been recognized as a Polish tax resident under a ratified double taxation treaty.

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RAFAŁ KOWALSKI
Head of Tax Department
tel.: +48 22 543 16 00
Rafal.Kowalski@bdo.pl

IX. Tax credits are deductible proportionally to taxed income

The discussed provisions also stipulate that in the case of a hybrid transaction resulting in relief being obtained by more than one entity in relation to withholding tax on performances on account of a transferred financial instrument, the taxpayer being a Polish tax resident is entitled to use the tax relief proportionally to taxable income related to such performance. Here, tax resident is an entity that, under domestic regulations, is tax liable on account of its entire income (revenues) regardless of the location of the sources of such revenues.

X. When applying the provisions, the investor's, recipient's and payer's respective countries must be determined

From the viewpoint of the hybrid structure provisions, concepts such as investor's country, recipient's country and payer's country are of great importance. The current CIT regulations provide that the investor's country is a country other than the payer's country, which grants the right to deduct a performance, cost or loss resulting in a double deduction. Further, the recipient's country is the country in which, under that country's law, the actual or hypothetical performance resulting in deduction without taxation is deemed received. The payer's country is the country where: the performance has its source or the costs or losses have been incurred – in the case of double deduction; the hybrid entity is established or the foreign permanent establishment is located - in the case of a performance made by the hybrid entity or foreign permanent establishment and resulting in a double deduction; the actual or hypothetical performance is deemed to have been made under the law of that country – in the case of deduction without taxation. Here, the term country also means a territory.

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BDO spółka z ograniczoną odpowiedzialnością sp.k., ul. Postępu 12, 02-676 Warszawa;
tel.: +48 22 543 1600, fax: +48 22 543 1601, e-mail: office@bdo.pl