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Thin capitalization in polish tax law

Thin capitalization is a term used in different branches of law. It generally describes situation in which a Company capital consist in majority from a debt rather than equity. If the equity of a Company is lower than the one required to conduct normal economical activity the shareholders often fill it up by granting a loan. Such situation may be considered negative by creditors of the Company which bear the solvency risk as well as tax authorities which may be concerned about excessive tax deduction. Therefore in many law systems legislator decides to implement measures to prevent thin capitalization. In Poland to prevent it certain provisions of tax law were implemented.

In polish tax law term thin capitalization is generally used in reference to the institution defined in Article 16 Section 1 Point 60 and 61 of the polish Corporate Income Tax ("CIT") act. Article 16 Section 1 of the CIT law determines set of costs which tax payers may not treat as the revenue earning costs. In other words all costs listed in the above mentioned provision will not be tax deductible. Therefore generally the tax payers to minimize tax burden should avoid incurring costs listed in the catalogue stipulated in the Article.

Points 60 and 61 of the above mentioned provision exempt from tax deductible costs certain interest. According to the point 60 interest:

1) on loans and credits granted to a company by its shareholder having at least 25% of the Company shares,

2) in case if the amount due by the company to its shareholders owning at least 25% of the Company shares and other entities owning at least 25% of the shares in the capital of such shareholder becomes three times bigger than the value of equity,

does not constitute tax deductible costs in amount in which the loan exceeds the value of the above mentioned debt calculated for the day of repayment of the interest.

In article 61 legislator decided to exclude from revenue earning cost interest:

1) on loans and credits granted to a company by another company, if the same shareholder owns at least 25 per cent of shares in each of those companies,

2) in case if the amount due by the company receiving the loan or credit to its shareholders owning at least 25 per cent of its shares, other entities owning at least 25% of the shares in the capital of such shareholder and the company granting loan is three time bigger than the equity of the company,

in amount in which the loan exceeds the value of the above mentioned debt calculated for the day of repayment of the interest.

Analysis of above quoted provisions leads to conclusion that limitation as regards possibility of treating interest as tax deductible exists in situation in which:

1) the loan is granted by shareholder which holds no less than 25% of the Company shares or by shareholders holding jointly no less than 25% of the Company shares,

2) the amount due to shareholders holding no less than 25% of the Company shares and other entities holding no less than 25% of such shareholders shares reaches three time value of the Company equity.

In other words interest paid to the following entities may be affected by thin capitalization tax restriction:

1) shareholders (both natural, legal persons and organizational units having no legal personality possessing legal capacity) holding 25% of the Company shares,

2) shareholders holding jointly 25% of the Company shares,

3) other companies (e.g. sister companies) if the shareholder of the company and the other company holds in both of them at least 25% of shares[1].

The thin capitalization provisions do not affect loans granted by other entities especially third persons not being shareholders or persons being shareholder but not holding at least 25% of the company shares[2]. As regards the company sisters limitation influence loans granted by sisters in case if the same shareholder hold at least 25% of the company shares and at least 25% of the sister shares[3]. In case of grandmother companies the thin capitalization rules does not apply[4]. The above mentioned examples as well as administrative court's rulings prove that extensive interpretation of provisions of Article 16 Section 1 Point 60 and 61 of the polish CIT law is forbidden[5]. It must me noted that regulations concerning thin capitalization will be applied not only to shareholders being polish tax residents but also to foreign entities[6].

The percentage of shares held by the company shareholder is calculated basing on the voting right of such shareholder[7]. Therefore in case in which the shareholder holds 10% of shares representing 10% of the Company equity but the shares are privileged and allows three votes each then, on the ground of thin capitalization rules, the shareholder holds 30% of the Company shares (assuming that no other shares are privileged)[8].

The interest do not constitute tax deductible costs only in part in which they are calculated from the amount exceeding three times the Company equity. The ratio is calculated on the day of debt payment[9]. The provisions of the CIT law do not clearly state what debts should be used for calculating proportion. Two possible ways of interpretation of the Law are possible:

1) that all debts from the entity should be used for ratio calculations,

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[1] Mariański A., Strzelec D., Wilk M., *Podatek dochodowy od osób prawnych. Komentarz.*, LEX 2012 (Commentary to Article 16 Point 58)
[2] Ruling of the Director of Katowice Tax Chamber of 27 April 2011 (IBPBI/2/423-212/11/MS)
[3] Ruling of the Director of Katowice Tax Chamber of 06 July 2011 (IBPBI/2/423-391/11/MS)
[4] Ruling of the Director of Katowice Tax Chamber of 06 July 2011 (IBPBI/2/423-391/11/MS); Ruling of the Director of Katowice Tax Chamber from 08 December 2009 (IBPBI/2/423-1082/09/PC)
[5] Ruling of the Voivodship Administrative Court in Warsaw of 12 October 2010 (III SA/Wa 1831/10)
[6] Mariański A., Strzelec D., Wilk M., Podatek dochodowy od osób prawnych. Komentarz., LEX 2012 (Commentary to Article 16 Point 58)
[7] T. Napierała, *Niedostateczna kapitalizacja*, GrantThornton 2003-10-15, http://grantthornton.pl/pl/artykuly_podatki.php?artid=57
[8] Mariański A., Strzelec D., Wilk M., *Podatek dochodowy od osób prawnych. Komentarz.*, LEX 2012 (Commentary to Article 16 Point 58)
[9] Małecki P., Mazurkiewicz M., *CIT. Podatki i rachunkowość. Komentarz.*, LEX 2012 (Commentary to Article 16 Point 11)

2) that only loans and credits constitute the proportion.

Most of tax authorities present a standpoint that all debts should be included in proportion. Such a view was presented inter alia by: Director of Tax Chamber in Poznań[10], Director of Tax Chamber in Katowice[11], Director of Tax Chamber in Łodź[12] and Director of Tax Chamber in Bydgoszcz[13]. The practice of administrative courts is patchy. Supreme Administrative Court in ruling of 13 April 2011 (II FSK 2117/09) presented a view that all debts should be used for proportion calculation. Similar standpoint was taken by Voivodship Administrative Court in Gdańsk[14]. Nevertheless several positive rulings, though mostly not yet legally valid, were also issued[15].

As regards calculating the equity the rules described in Article 16 Section 7 of the CIT law should be applied. Therefore the company should exclude from equity:

1) capital which was not carried in,

2) capital which was created from loans and credits granted to the Company by the Company shareholder as well as interest from such loans and credits,

3) part of capital which was created from intangible assets from which depreciation write-offs are not possible.

There are several ways in which the tax payer can try to avoid thin capitalization restrictions. The company may for example first pay the nominal value of debt and then pay interest due. As neither the tax law nor the civil law contains any restrictions as regards the date of interest payment the agreement may state that payment of interest will take place after paying the nominal value of debt. In such a case the debt (calculated on the date of interest payment) possibly will be lower then three times the Company equity and therefore thin capitalization provisions will not apply[16].

The Company may also consider transferring loan to another creditor. It must be noted though that it is unclear whether if the creditor was shareholder of the Company on the moment of granting a loan and then transferred the debt to another entity the thin capitalization rules will still apply. However according to some rulings the status of shareholder should be verified on the moment of debt payment[17].

The provisions as regards thin capitalization in Poland are quite imperfect and therefore may be quite easily circumvented. Nevertheless while considering intergroup loans the consequences of Article 16 Section 1 Point 60 and 61 of the CIT law should be taken into account.

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[10] Ruling of the Director of Poznań Tax Chamber of 02 December 2011 (ILPB3/423-425/11-2/EK)
[11] Ruling of the Director of Katowice Tax Chamber of 27 April 2011 (IBPBI/2/423-212/11/MS)
[12] Ruling of the Director of Łodź Tax Chamber of 23 November 2011 (IPTPB3/423-207/11-2/IR)
[13] Ruling of the Director of Bydgoszcz Tax Chamber of 31 May 2010 (ITPB3/423-148/10/PS)
[14] Ruling of the Voivodship Administrative Court in Gdańsk of 25 October 2010 (I SA/Gd 661/10)
[15] Ruling of the Voivodship Administrative Court in Warsaw of 03 December 2010 (III SA/Wa 2365/10); Ruling of the Voivodship Administrative Court in Bydgoszcz of 09 November 2010 (I SA/Bd 815/10)
[16] Ruling of the Director of Bydgoszcz Tax Chamber of 06 June 2010 (IPPB3/423-149/10-3/AG)
[17] Ruling of the Voivodship Administrative Court in Warsaw of 12 January 2011 (III SA/Wa 1052/10)