KSP TAX NEWS 11/2012

We are pleased to present to you KSP Tax News bulletin in which we describe selected rulings and interpretations passed or published in October 2012. We hope this publication proves useful in your everyday business life

Contractual Penalty as Deductible Cost - Judgment by NSA

On 3 October 2012 the Supreme Administrative Court (NSA) (ref. II FSK 2597/11) resolved that a contractual penalty paid for non-fulfillment of a contractual obligation, together with interest accrued thereon, may constitute deductible costs provided that the non-fulfillment was justified and served to retain the source of revenue. A failure to perform an obligation is justified if its purpose is to avoid higher costs, e.g. of damages, and if it is intended to secure the source of revenue. In this light, NSA considered it justified that a decision was taken not to fulfill the agreement, i.e. to sell shares to a subsidiary on the free market rather than to the contracting party at grossly underestimated price. Consequently, the company received a price which significantly exceeded the total cost of the contractual penalty and arbitration proceedings, and additionally, it avoided potential damages to be paid to the subsidiary for acting to its detriment.

Expert Comment

"Article 15 of the CIT Act provides that a deductible cost is the expense incurred to derive revenue or to retain or secure a source of revenue. Exceptions from the rule are listed in Article 16 par. 1 of the CIT Act and include, inter alia, under subparagraph 22, contractual penalties and damages paid for defects in goods, works and services as well as for delay in delivery of goods free of defects and delay in removal of defects in goods, works and services. An analysis of the provision indicates that it does not apply to contractual penalties for failure to perform an obligation, and the provision should be interpreted strictly. Such was the interpretation of NSA when the Court stated, contrary to the opinions expressed by tax authorities, that a link may exist between payment of damages and deriving or securing a source of revenue, e.g. in a situation where the payment of a contractual penalty safeguards against incurring costs higher than those involved in fulfillment of the original obligation. This standpoint is convergent with the individual interpretation issued by the Minister of Finance on 11 October 2012 (ref. IPPB1/415-872/12-2/AM), which confirms that withdrawal from an agreement and payment of damages or contractual penalty (for reasons other than listed

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under Article 16 par. 1.22 of the CIT Act) may be classified as deductible costs if it is more favourable for the taxpayer than due performance of the obligation. However, it is of key importance to prove the link. The verdict is favorable for taxpayers. As a rule, it makes it possible to classify expenses incurred for contractual penalties as deductible costs. However, in this situation it should be emphasized that recognition of such expenses as deductible costs may only be made after it is proven that they were incurred in order to secure or retain the taxpayer's revenue".

CIT

The Supreme Administrative Court in the judgment of 18 October 2012 (ref. II FSK 416/11) resolved that one of the conditions for recognizing an unrecoverable debt as a deductible cost is to document its unrecoverable status with the report referred to in Article 16 par. 2.3 of the CIT Act.

The Court stated that the report should strictly conform to the statutory requirements. It means that it should specify the amount of the costs to be incurred for judiciary process and enforcement of the asserted claim. If it does not specify such costs, the statutory requirements are not met. Thus, the report is unreliable and cannot be the basis for recognizing the debt as unrecoverable (the debt documented with the report cannot be charged to deductible costs). So, if the taxpayer is not in a position to anticipate the judicial and enforcement costs incurred to assert the claimed amount, he cannot draw up the report in compliance with the provisions of the CIT Act. Tax authorities and administrative courts agree in this respect. They emphasize that failure to indicate, in a reliable and verifiable manner, the anticipated judiciary and enforcement expenses means that the statutory requirements are not met. When estimating the probable enforcement expenses, an expert opinion will be helpful and reliable.

In the judgment of 17 October 2012 (ref. II FSK 467/11) the Supreme Administrative Court confirmed that vehicle operating/maintenance costs excluded from deductible costs under Article 16 par. 1.51 of the CIT Act do not encompass the rent fee paid for car rental.

NSA sustained the standpoint previously expressed in the Judgment of 16 March 2012 (ref. II FSK 2030/10). The Court emphasized that the costs related to vehicle rental were to be split into: costs of the fee for the legal title to use the vehicle and costs related to operation of the vehicle for the purpose of business activity. Expenses related to operation and maintenance of the car, i.e. parking fees, fuel, spare parts, repairs (i.e. operating expenses) are tax deductible only up to the amount stipulated in Article 16 par. 1.51 of the CIT Act, i.e. the amount indicated in the vehicle mileage log. The rental fee is paid for making the car available and it may be considered a deductible cost without limitations in accordance with the general principle expressed in Article 15 par. 1 of the CIT Act which provides that deductible costs are those incurred to derive revenue or retain and secure the source of revenue. The judgment is positive, as it makes it possible for taxpayers to recognize the entire amount of the payment made for car rental as a deductible cost,

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irrespective of the costs incurred for its operation. It should be emphasized that tax authorities are quite restrictive when it comes to recognizing operating expenses as deductible costs.

The Supreme Administrative Court, in the judgment of 25 October 2012 (ref. II FSK 271/11) resolved that the value of debt indicated in the "thin capitalization" regulations, encompasses not only debts resulting from loans, but also those incurred otherwise.

As a rule, interest on loans extended by major shareholders to the value exceeding three times the share capital must not be classified as tax deductible pursuant to Article 16 par. 1.60 of the CIT Act. The Company, in an individual interpretation, expected a confirmation of whether the value of debt should consist only of the debt from loans given by shareholders. This opinion, however, was not confirmed by NSA. The Court stated that had the legislator wanted to limit the value of debt to commitments resulting from loans only, he would have explicitly provided for such a limitation in the CIT Act. The court was of the opinion that the value of debt was a general notion, and covered any debts existing with respect to major shareholders, not only those resulting from loans incurred. It is another negative judgment concerning the interpretation of the notion of "value of debt" recently issued by NSA (similar was the NSA's Judgment of 10 January 2012, ref. II FSK 1324/10). In the past, administrative courts issued judgments favourable for taxpayers, indicating that "the value of debt" in the context of thin capitalization must not be interpreted without taking account of the definition of a loan, as provided in Article 16 par. 7b of the CIT Act (e.g. the judgment by WSA in Warsaw, of 3 December 2010, ref. III SA/Wa 2365/10). However, in the light of the NSA's judgment, it may be expected that the authorities and courts will adopt a restrictive approach to this area in the future. Additionally, the planned amendment to the CIT Act includes a more precise definition of the notion of "debt" by indication that it includes the entire amount due to an entity.

VAT

The Province Administrative Court of Gliwice, in the judgment of 8 October 2012 (ref. III SA/Gl 976/12) resolved that a marketing service which included development and conduct of an advertising campaign was a comprehensive service also in a situation where it involved distribution of gadgets and other advertising materials.

The Company concluded an agreement with an advertising agency for development and conduct of a marketing campaign to support the wholesale of drinks. As part of the campaign, the agency planned to distribute gratuitous gadgets to certain groups of clients and to give prizes in contests to be held. The taxpayer was of the opinion that, despite distribution of the gadgets (performance in-kind), the entire activity should be considered a service within the meaning of the VAT regulations. The Head of the Fiscal Chamber in Katowice in an individual interpretation did not recognize the service as a comprehensive one, and stated that it should be divided into an advertising service and a supply of goods to specific customers which is paid for by the party ordering the advertising service. WSA of Gliwice did not share this

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opinion. The Court stated that the advertising campaign which involves distribution of gadgets is a service within the meaning of VAT regulations, and its division into a supply of goods and provision of services contradicts the subject matter of the service, the more so that the distribution of gadgets and prizes was secondary with respect to the service provided as a whole. The judgment should be evaluated as positive, since it explains the manner of levying taxes on complex services, and emphasizes that the subject matter of the service is what signifies in such situations rather than artificial division into component parts.

The Head of the Fiscal Chamber of Katowice in the individual interpretation of 2 October 2012 (ref. IBPP1/443-685/12/AW) stated that in the event of withdrawal from an agreement involving a refund of the advance payment made, an adjusted invoice can be issued and the output tax can be reduced only upon the actual repayment of the advance.

The Company documents advance payments made by contractors with VAT invoices. If the contractor withdraws from the agreement, the advance payments made are repaid. The Company was in doubt whether the adjustment invoice was to be issued on the date of withdrawal from the agreement or after the actual repayment of the advance, and whether repayment of the advance was necessary to reduce the output VAT. The Company was of the opinion that the date of withdrawal from the agreement was decisive. However, the tax authority considered the standpoint as incorrect and stated that repayment of the advance was necessary to issue the adjusted invoice. The Head of the authority stated that, as the VAT payment obligation arose upon receipt of the invoice, it was the actual repayment of the advance that authorized the Company to issue the adjusted invoice. By the same token, upon receipt of the confirmation of adjusted invoice receipt by the contractor, the taxpayer may adjust the output VAT. The interpretation is consistent with the standpoint presented by tax authorities in similar situations to date. The standpoint is that if a receipt of an advance payment towards a future performance caused the VAT payment obligation to arise, and the fact is documented with an invoice, the adjustment must apply to the transaction which gave rise to the tax obligation, i.e. receipt of the advance. Thus, only repayment of the advance eliminates the tax obligation arisen as a result of its receipt, and it should be documented with a relevant adjusted invoice.

EXCISE DUTY

The Supreme Administrative Court, in the resolution adopted by seven judges on 29 October 2012 (ref. I GPS 1/12) resolved that excise imposed on lubricating oils which do not fall under the category of energy products within the meaning of the Energy Directive remains within the scope of the authorization provided for in Article 3 par. 1 of the Horizontal Directive and is compliant with the Community law.

The Energy Directive provides that lubricating oils used for purposes other than as motor fuel and heating fuel are not subject to harmonised excise duty.

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The Horizontal Directive provides for the possibility of levying taxes on the products (other than harmonised excise duty) provided that the taxation does not give rise to formalities connected with the crossing of frontiers. As the excise duty is levied on such products in Poland, discrepancies have occurred in the rulings issued. Some of the judgments stated that levying the excise duty on lubricating oils was not compliant with the Community law. However, in the resolution, NSA stated that the authorization to levy the tax on said products was not limited by type, and the Polish legislator was entitled to apply the excise duty or a tax identical to excise. NSA also stated that no additional formalities connected with the crossing of frontiers were imposed on taxpayers with respect to formal conditions to apply the excise duty exemption within Poland. Said resolution is not favourable for taxpayers, as the Polish regulations providing for levying the excise duty on lubricating oils used for purposes other than as heating or motor fuel are approved as conforming to the Community law. However the Resolution does not put an end to the dispute between the taxpayers and tax authorities, one of the reasons being that the aforesaid case applied only to a situation of those taxpayers who use the exemption from excise duty on lubricating oils. The Court did not refer to e.g. conformity with the EU law of the formalities imposed in connection with intra-Community acquisition. Therefore, it can be argued that in view of the facts, the resolution will not be binding for the administrative court that deals with a specific case.

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If you wish to be provided with additional information in this respect, please contact us.

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