Portugal: Recent and Pending Cases

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I. Brisal – Auto Estradas do Litoral S.A., KBC Finance Ireland v Fazenda Pública, Case C-18/15

A. Facts

At the time when the facts occurred in *Brisal*, interest payments received by non-resident financial institutions were submitted to a final withholding tax of 20 % or lower under a double taxation convention, on gross income, with no possibility of deducting business expenses directly related to the financial activity carried out. In contrast, resident financial institutions were submitted to a corporate income tax rate of 25 %, on net income: the interest received by resident financial institutions is incorporated in the total taxable income, with deduction of any expenses related to the activity pursued when determining the profit for the purposes of corporation tax, so that the basic rate of 25 % was applied to the *net* interest income.

Although the following aspects have not been mentioned in the referral, it is worth adding, that Portuguese banks also benefit from no withholding tax on payments of interest to a permanent establishment of a Portuguese bank established outside Portugal; that interest on loans granted to resident credit institutions by non-resident financial institutions is exempt from tax, provided that such interest is not attributable to a Portuguese permanent establishment of the non-resident financial institution; and that interest on time bank deposits made by non-resident credit institutions is exempt from tax.

B. Questions Referred

The Portuguese Supreme Administrative Court (2nd Chamber), referred the following questions to the CJEU:

> "Does Article 56 TFEU preclude national tax legislation under which financial institutions not resident in Portuguese territory are subject to tax on interest income received in that territory, withheld at source at the definitive rate of 20 % (or at a lower rate if there is an agreement to avoid double taxation), a tax applied to gross income with no possibility of deducting business expenses directly related to the financial activity carried out, whereas the interest received by resident financial institutions is incorporated in the total taxable income, with deduction of any expenses related to the activity pursued when determining the profit for the purposes of corporation tax, so that the basic rate of 25 % is applied to the net interest income?"
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> 2. "Does the same hold good even if the tax base of resident financial institutions, after deduction of the financing costs related to the interest income, or of expenses directly related, economically, to such income, is or may be subject to a higher tax than is deducted at source from the gross income of non-resident institutions?"
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> 3. "For this purpose, can the financing costs associated with the loans granted, or the expenses directly related, economically, to the interest income received, be proved by the data provided by the EURIBOR ('Euro Interbank Offered Rate') and by the LIBOR ('London Interbank Offered Rate') — which represent the average interest rates charged on interbank financing used by banks to carry out their activity?"

In short, the issues are whether the regime is incompatible with the free movement of capital (current Article 63 TFEU); whether the same holds true where net taxation applicable in the concrete case is more burdensome; and whether the financing costs associated with the loans granted can be proved by the data provided by the EURIBOR (Euro Interbank Offered Rate) and by the LIBOR (London Interbank Offered Rate) – since these correspond to the average interest rates charged on interbank financing.

Meanwhile, there have been developments in the Portuguese tax regime. The current statutory Corporate Income Tax rate is 21 % and the withholding tax rate is 25 %, widening the gap between the applicable tax rates; non-resident corporate taxpayers can now elect to be handled as Portuguese residents and the withheld tax can be reimbursed. The cash-flow disadvantage in the application of a withholding tax is clear and typically not applied in internal situations where Portuguese banks are concerned.

C. Brisal as a follow-up to C-105/08 Commission vs Portugal

Brisal is a follow-up to the CJEU case *Commission vs Portugal*[1], where the Court did not rule on the material question on the grounds of lack of data presented by the European Commission to assess the issues (reason for third question referred to allow domestic court to make a similar assessment).

According to the decision:

> ”…it is incumbent upon the Commission to prove the allegation that an obligation has not been fulfilled. It is the Commission's responsibility to place before the Court the information required to enable the Court to establish that the obligation has not been fulfilled, and in doing so the Commission may not rely on any presumption.”[2]
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> ”In the present case, in order to prove that the Portuguese legislation, which, it is not disputed, treats resident and non-resident legal entities differently with regard to IRC, results in higher taxation of non-resident legal entities, the Commission relies on an arithmetical example based on the assumption that the profit margin achieved by the entity in question in that example is 10%”.[3]
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> “In so far as the calculation in question, which the Commission itself describes as ‘theoretical’, is disputed by the Portuguese Government on the ground that the premiss underlying it bears no relation to the true position, and since that government puts forward a calculation based on a different profit margin which produces a solution in which resident legal entities are taxed more heavily, the onus was on the Commission, as the Advocate General observed at point 40 of her Opinion, to establish that the figures on which its calculation is based reflect the economic reality. Thus, the Commission could have furnished, inter alia, statistical data or information concerning the level

1 *Commission v Portugal*, C-105/08, EU:C:2010:345.
2 *Commission v Portugal*, C-105/08, EU:C:2010:345, para. 26.
3 *Commission v Portugal*, C-105/08, EU:C:2010:345, para. 27.

> of interest paid on bank loans and relating to the refinancing conditions in order to support the plausibility of its calculations."[4]
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> "It is however, clear that, in the present case, the Commission failed to produce either during the written procedure or the hearing, and not even after an express request by the Court, any conclusive evidence whatever which would have been capable of establishing that the figures which it puts forward in support of its argument are in fact borne out by the actual facts and that the arithmetical example on which it relies is not purely hypothetical."[5]

It seemed clear that the Court would assess whether the Portuguese regime was incompatible with the free movement of capital, if a Portuguese court referred a concrete case on the basis of infringement procedures. *Brisal* is therefore an opportunity to obtain clarity on the compatibility of the Portuguese regime with the TFEU. Moreover, it is desirable that the CJEU does not adopt the position held in the *Truck Centre* case[6], where the comparison test was mainly focused on Belgium and its position as a source country in the case, and the Court neither focused on the meaning and scope of the fundamental freedoms, nor on the taxpayers, as the right beneficiaries of the fundamental freedoms: it was considered that Belgium did not have to handle interest accrued by non-residents and residents in the same manner, because as source state it was not in the same position when acting as a residence state:

> "In that regard, the difference in treatment between companies receiving income from capital, established by the tax legislation at issue in the main proceedings, consisting in the application of different taxation arrangements to companies established in Belgium and to those established in another Member State, relates to situations which are not objectively comparable.
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> Firstly, when both the company paying the interest and the company receiving that interest are resident in Belgium, the position of the Belgian State is different to that in which it finds itself when a company resident in Belgium pays interest to a non-resident company, because, in the first case, the Belgian State acts in its capacity as the State of residence of the companies concerned, while, in the second case, it acts in its capacity as the State in which the interest originates.
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> Secondly, the payment of interest by one resident company to another resident company and the payment of interest by a resident company to a non-resident company give rise to two distinct charges which rest on separate legal bases."[7]

If the CJEU considers that the Portuguese regime under analysis is discriminatory, it will have to specify which expenses (financial costs) are deductible. It is herein contended that an optional regime, allowing the election to be handled as a resident taxpayer is the best solution in light of the TFEU, because the non-resident taxpayer will not always be favoured by adopting the latter regime.[8]

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4 *Commission v Portugal*, C-105/08, EU:C:2010:345, para. 29.
5 *Commission v Portugal*, C-105/08, EU:C:2010:345, para. 30.
6 *Truck Center*, C-282/07, EU:C:2008:762.
7 *Truck Center*, C-282/07, EU:C:2008:762, paras. 41–43.
8 See A.P. Dourado & J.Almeida Fernandes, *The Infringement Procedures involving Portugal*, in: M. Lang et al. (eds.), *ECJ – Recent Developments in Direct Taxation 2008* (Vienna: Linde, 2008) p. 337.

II. Case C-343/13 Modelo Continente Hipermercados SA v Autoridade para as Condições do Trabalho — Centro Local do Lis (ACT)

A. Facts

On 24 June 2013 there was a request for a preliminary ruling from the Tribunal do Trabalho de Leiria (Portugal) concerning the following facts: on 15 February 2011 an inspection was carried out by the Portuguese Authority for Labour Conditions (ACT) at one of the Lisbon stores of the company ”Good and Cheap Comércio Retalhista, SA” (GC)During this inspection the company was requested to present certain documents. On 31 March 2011, ”Modelo Continente Hipermercados, SA”, a public limited liability company, acquired GC, including the store that had been previously inspected. Its assets were globally transferred to Modelo.

After the registration of the merger, ACT served the wound up company GC with a report informing it of the application of an administrative penalty due to the violation of labour laws. Article 19 of Directive 2011/35/EU was transposed by Article 112 of the Portuguese Commercial Companies Code:

> "With the registration of the merger on the competent legal institution:
> a) The merged companies are wound up or, in the case of the creation of a new company, all the merged companies are wound up. Its rights and obligations are transferred to the acquiring company or to the new company;
> b) The shareholders of the wound up companies become shareholders of the acquiring or new company." (author's translation)

B. Questions referred to the CJEU

The following questions were referred to the CJEU:

> "1. In the light of Community law and, in particular, Directive 2011/35/EU and Article 19 thereof, does the merger of companies entail a system of transfer of liability for administrative offences to the acquiring company for acts committed by the company being acquired before registration of the merger?
> 2. Can a penalty for administrative offences be considered a debt owed to third parties (in the present case the State, for infringement of rules concerning administrative offences) for the purposes of the application of the Directive, with the consequence that the corresponding debt (fine) for an administrative offence, in respect of which the State is the creditor, is transferred to the acquiring company?
> 3. Does an interpretation of Article 112 of the PT Commercial Companies Code according to which it does not imply termination of proceedings for an administrative offence committed before the merger, or of the corresponding fine to be imposed, conflict with the abovementioned Community Directive, which sets out the consequences of a company merger, thereby constituting a broad interpretation of the provision contrary to the principles of Community law and, in particular, Article 19 of the Directive?

4. Does that interpretation constitute a breach of the principle that there can be no administrative offence without strict (mitigated) liability or liability for fault on the part of the acquiring entity?"

C. Reasoning

It was established in the CJEU Case C-90/09P[9] (a competition law case – on the transfer of liability to a parent company) that there was no transfer of liability for administrative offences to the acquiring company for acts committed by the company being acquired before registration of the merger as long as there was no decisive influence in the behaviour that constituted an offence.

It had been contended in a previous analysis of Case C- 343/13, that the need to define the concept of creditor for the purposes of the Directive might lead the Court to apply the private creditor's test, used by the Court in state aid cases.[10]

Although this is not a tax case, the relation that the author previously established with tax cases arose from the case law of the Court on the transmission of losses from the acquired company to the acquiring company, in the context of the Directive 2009/133/EC of 19 October 2009 on the taxation of mergers.[11]

It was also contended that the arguments by the CJEU in its case law on the transmission of losses could not be transposed to this case, because the administrative offence has to be based on a subjective liability of the company. The latter requires an unlawful and guilty behaviour to be proved and it is an *ad personam* kind of liability.

On the other hand, the deduction of losses is related to objective facts (taxable base).

It was also claimed that there could be no administrative offence without strict (mitigated) liability or liability for fault on the part of the acquiring entity.[12]

D. The CJEU decision

In the case under analysis, C 343/13, the CJEU decided differently from the aforementioned case C-90/09P and from the author's previous arguments and assessment. Rather, it decided that a merger by acquisition in Article 3 (1) of the Directive implies the transfer by the acquiring company of the obligation to pay a fine committed by the acquired company prior to the merger and imposed by final decision after the merger.[13]

9 *General Química and Others v Commission*, C-90/09P, EU:C:2011:21.
10 See A.P. Dourado & A.G. Rocha, *Recent and Pending Cases at the ECJ on Direct Taxation: Portugal (case C-343/13)*, in: M. Lang et al. (eds.), *ECJ – Recent Development in Direct Taxation 2013* (Vienna: Linde, 2014) p. 197.
11 See *Foggia*, C-126/10, EU:C:2011:718.
12 A.P. Dourado & A.G. Rocha, in: M. Lang et al. (eds.), *ECJ – Recent Development in Direct Taxation 2013* (2014) p. 198.
13 *Modelo Continente Hipermercados*, C-343/13, EU:C:2015:146, para. 35.

And, according to the CJEU, in paragraph 33 of the same decision, "if such liability were not transferred, a company could use a merger by acquisition as a means of escaping the legal consequences of offences it has committed to the detriment of the Member State concerned or other potential interested parties".

III. C-464/14 Secil

A. Free movement of capital and third countries

The *Secil* case concerns a potential discriminatory treatment of inbound dividends from third countries and it is an opportunity for the CJEU to decide on a number of new topics related to the fundamental freedoms (more specifically, free movement of capital) and third countries. It is also an opportunity for the CJEU to further develop its doctrine on a group of issues that cannot yet be considered acte clair, namely: the direct effect of provisions in the association agreements on fundamental freedoms and their impact in direct taxes; the overlapping of fundamental freedoms; vertical and horizontal discrimination; the standstill clause under Article 64 paragraph 1 of the TFEU.

B. Facts

Secil is a resident company in Portugal with subsidiaries in Lebanon and Tunisia, countries that are neither party to the European Union, nor the EEA, but with which association agreements have been concluded. Under the Portuguese corporate income tax code, incoming dividends from Lebanon and Tunisia fall into the general tax regime which implies higher taxation than the one to which domestic dividends and dividends coming from the European Union and EEA Member States are submitted.

C. Detailed and precise questions referred (as recommended by the CJEU to domestic courts)

The competent first instance tax court – referred the following questions to the CJEU:

"1. Does Article 31 of the Agreement with Tunisia constitute a provision which is clear, precise and unconditional and, as such, directly applicable, and from which it must be inferred that the right of establishment is applicable to the present case?
2. If so, does the right of establishment under that provision entail the consequences which the applicant claims, in the sense that, if that right is not to be infringed, it requires that the full deduction mechanism provided for in Article 46(1) of the CIRC [(Code on corporation tax)] be applied to the dividends which the applicant received from its subsidiary in Tunisia?
3. Does Article 34 of the Agreement with Tunisia constitute a provision which is clear, precise and unconditional and, as such, directly applicable, and from which it must be inferred that the free movement of capital is applicable to the present case and must therefore be regarded as covering the investment made by the applicant?