

EUROPEAN COURT OF JUSTICE RULING ON
CROSS-BORDER NET TAXATION OF
INTEREST (CASE BRISAL KBC)

INTRODUCTION

The Court of Justice of the European Union (Court) ruled, on July 13, 2016, following a request for a preliminary ruling, in Case C-18/15, Brisal KBC. The case concerned the taxation at source on the gross amount of interest payments paid to financial institutions that are non-resident in Portugal, whereas resident financial institutions in Portugal were taxed, under the Portuguese tax legislation, by reference to the net amount, thus allowing the deduction of expenses related to the cost of its financing activity.

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This issue of cross-border taxation of interest has a long history, as recognized by the Organisation for Economic Co-operation and Development (OECD). It may be exemplified, as in case Brisal KBC, with the deduction or non-deduction of costs related to the activity of a financial institution, whether direct or indirect, and, in particular, refinancing costs in which a financial institution traditionally incurs. That is, the problem lies in considering, or not, for tax purposes, costs related to the loans or other financing granted by a financial institution.

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Although some double tax treaties concluded by Portugal allow the exemption from taxation of these payments at source, most of the treaties do not allow such treatment. Therefore, it is expected that the Court's decision will have a significant impact on cross-border loans granted by non-resident financial institutions within the European Union (EU) and European Economic Area (EEA).

1. BACKGROUND

In 17 July 2016, the Court ruled, again, on the issue of cross-border interest taxation at the source, in order to determine whether the Portuguese legislation on this matter respected the fundamental freedoms and access to the internal market and, more specifically, freedom to provide services.

When, in 2008, the Court was faced with the same problem, it dismissed the infringement action brought by the European Commission (v. Portugal, C-105/08). The case was ruled against the Commission for lack of facts capable of proving the actual existence – and through the application of the system of taxation at source of interest – of actual damages or less favorable treatment to non-residents.

This new case concerned a financing agreement between the Portuguese company 'Brisal - Auto Estradas do Litoral SA' and the Irish Bank 'KBC Finance Ireland'. In this context, Brisal was obliged to pay a total

amount of € 350 806.00 on interest to KBC, of which € 59 386.00 was deducted at source and handed to the Portuguese Tax Authority. As such, the concerned tax was a tax payable on interest paid by a resident company in Portugal to an Irish financial institution that is non-resident in Portugal.

Both Brisal and KBC disagreed about the withholding of a part of said interest because it was applicable, only and specifically, to cases in which the borrower is resident in Portugal and the lender is a non-resident. In this context, they considered that the non-resident financial institutions are subject to higher taxation than resident financial institutions.

It should be noted that, according to the Corporate Income Tax Code, the financial institutions that are not tax residents in Portugal are subject to a special withholding tax at a flat rate of 20% levied on the gross amount that is earned as income. While identical financial institutions that are tax resident in Portugal have the interest income taxed at a rate of 25% levied on the net amount and do not need to withhold tax at source, allowing for a further cash-flow advantage.

Such dissociation raises the question of whether this difference is due to objectively different situations, or rather an effective discrimination between resident financial institutions and non-residents. In the second case, the application of such a decoupled and distinct system would be in violation of the

European Union rules on the freedom to provide services.

Through a domestic appeal and as a result of Brisal and KBC's opposition in having a portion of the interest due be withheld at source, the Supreme Administrative Court (STA) was asked to rule on the issue raised by this tax. The STA then initiated the preliminary ruling procedure before the Court, so that it interpreted and determined whether EU law opposed this outcome of the Portuguese domestic tax law.

2. THE FREEDOM OF PROVISION OF SERVICES

The freedom to provide services, by nature, aims to protect the relationships and cross-border business. In this context, "all measures which prohibit, impede or render less attractive the exercise of the freedom to provide services must be regarded as restrictions of that freedom 'the exercise of cross-border services,' that is when the provider and the recipient of the services concerned are established in different Member States.

The higher taxation imposed on the non-resident financial institution, where it is not justified by objectively different situations, may restrict or create obstacles to the provision of cross-border services. In this case, the differentiation makes the provision of services by the KBC, non-resident financial institution, less attractive than the provision of services by a resident financial institution.

The Portuguese domestic law on interest taxation allows resident financial institutions to deduct, a priori, professional expenses. Asymmetrically, it does not recognize their non-resident counterparts the possibility of deducting said expenses. Consequently, resident entities are taxed on their net income, whereas non-resident entities are taxed on their gross income. Therefore, Portugal offers more favorable conditions to strictly domestic service provisions by resident financial institutions than it does to cross-border service provisions by identical non-resident financial institutions.

Based on this finding, the Court concluded that the national legislation at issue conflicts with the freedom to provide services, by making it less attractive for non-resident financial institutions to pursue their activity.

3. CONTENT OF THE DECISION

In its decision, the Court took the opportunity to point out that according to the Treaty of Functioning of the European Union and, more specifically, the freedom to provide services there is no distinction between different service categories. In accordance to the Treaty, "the liberalization of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalization of movement of capital." On the other hand, a restriction on the freedom to provide services is accepted only in specific conditions, in particular where such

may be "justified by overriding reasons of general interest" and as long as said justification respects the principle of proportionality.

The Court considered that the unfavorable tax treatment for non-resident entities is not consistent or compatible with EU law. Consequently, it considered that the fundamental freedoms opposed domestic law such as the one here at stake. The difference cannot be justified based on the potential existence of other benefit, which would, in this case, lead to the application of a lower tax rate for resident financial institutions.

In the same line of reasoning, the Court noted that, while recognizing in its case law, the need to ensure the effectiveness of tax collection is an imperative reason of overriding public interest which can justify a restriction on the freedom to provide services. However, it also reminded that this justification is only valid within the limits of the principle of proportionality. That is, the legislation must be appropriate to ensure the attainment of the pursued objective and may not go beyond the necessary to achieve it. The Court concludes that the restriction at issue in the main proceedings is not necessary to ensure the effective collection of corporate income tax.

In addition, the Court recognizes that in the absence of unification measures or supranational harmonization, the competence to determine the criteria for allocating taxing powers between EU Member States, in order

to eliminate cases of double taxation, remains in the hands of the Member States, which address the issue through bilateral agreements that aspire to avoid double taxation said. However, double taxation conventions do not replace the obligations that are imposed on Member States within the EU Treaties, inter alia, the principle of equal treatment and the freedoms of movement guaranteed by the primary law of the EU.

Therefore, in light of the legal and factual elements in *Brisal KBC*, non-residents should be treated the same way as residents. Consequently, non-resident financial institutions should be allowed to deduct their business expenses to their taxable income. Necessarily, granting a financial loan implies business expenses (travel expenses, counseling, etc.), and all taxpayers, both those who are fully taxable as those who are partially taxable, should benefit from the same treatment. Therefore, they should be offered the same opportunities for deduction of those expenses. In this context, the Court also recognized (re-)financing costs as business expenses of a financial institution.

Moreover, the Court also noted that the mere difficulty of proof does not authorize a Member State to deny to non-residents the privileges that it grants to the residents. Nothing prevents the concerned tax authorities from requiring the non-resident person evidence that they deem necessary to assess whether the cost deductibility requirements are met.

Based on this reasoning, the Court considered that a different tax treatment between resident and non-resident taxpayers is permitted insofar as that is justified and necessary and that, in *Brisal KBC*, that was not the case. In respect of the freedom to provide services, the domestic law should allow the non-resident taxpayers to deduct directly related (professional) costs in which it incurs in the context of their activity, if resident taxpayers are allowed to do so.

4. THE (POTENTIAL) SOLUTION SUPPLY OFFERED BY OECD MODEL CONVENTION

Having the double tax treaties concluded by Portugal as a background, we should highlight the existence (or nonexistence) of a paragraph, in particular one that appears only as a suggestion, by the OECD, in comments to the Model Convention on double taxation on income and capital, usually provides the basis for the conclusion of the said conventions.

This suggestion-paragraph arises after the clear realization, by all OECD Member States, who consensually agree on the amendments to the Commentaries, that this issue was relevant and that it was important to sketch a solution, even if merely as an option. Therefore, the Commentaries to the Model Tax Convention that concern interest taxation propose a possible solution for this issue.

The result proposed by the OECD would lead to exclusive taxation in the State of the interest recipient (beneficiary), thus imposing

a restriction on the right to tax the interest in these cases in the source State. This possibility depends, always, on the inclusion of such paragraph in the double tax treaty actually concluded by the States, so that the issue of cross-border interest taxation on gross vs. net basis is resolved.

In *Brisal KBC* such provision was not applicable because the double tax treaty concluded between Portugal and Ireland did not include such additional paragraph (as is the norm in tax treaties concluded by Portugal).

It should yet be remarked that the solution proposed by the OECD leads to a different outcome when than compared to the Court's decision, insofar as the first, if adopted, imply exemption in the source State, while the second allows the source State to tax, although it safeguards and allows the deduction of financing related costs. Even though the Court's decision is not yet of direct and general application, the taxpayers may, namely, in line with the decision in *Brisal KBC*, ground a request before the tax authorities or the courts.

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