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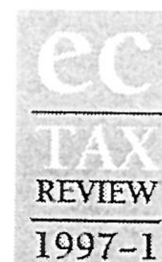
The Court attempted to achieve this equilibrium in the *Bachmann* case,[16] but did so on a basis that convinced no one, because it tried to turn pragmatism into principle and failed. The pragmatism was, nonetheless, justified by the result. An appeal to the principles of fairness and justice, and a recognition that sophisticated systems evolved over decades with a recurring reference to their democratic foundations cannot be dismissed like false labelling on food, would lead to better results. The European Court of Human rights has shied away from interfering with the fairness of income tax systems except in obvious cases. Its sister court at Luxembourg would do well to show a similar caution lest it be left bearing the responsibility for destroying the fairness of the current fiscal systems of Member States, while putting nothing in their place; it cannot claim that power without accepting that responsibility.

[16] *Bachmann*, C-204/90 [1992] ECR 1-249.

Impact of non-discrimination principle on Portuguese income tax law



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1. Introduction

The impact of the Community law non-discrimination principle on Portuguese tax law is practically non-existent. In fact, if we search for recent changes that have been made to internal tax law, we will not find any connection with the referred principle, but mainly with objectives of budgetary policy, like taxing imported investment as much as possible[1] and tax-avoidance clauses. Alterations related to EC law have only been a result of harmonizing directives.

In this article our aim is to inform the reader of the Portuguese personal and corporate income tax rules which we consider discriminatory and restrictive of free movement of persons, services and capital, according to the EC Treaty. To this purpose we shall consider that non-discrimination involves not only a principle of national treatment,[2] which prohibits less favourable treatment of non-residents, foreigners or imported investment, but also a less favourable treatment of residents in relation to income obtained abroad. According to the doctrine[3] and evolution of the jurisprudence of the ECJ, non-discrimination is closely linked with the right of free movement enshrined in the EC Treaty,[4] and thus we must consider this connection.

So that the reader may have a better understanding of the author's position in respect of the Portuguese discriminatory personal and corporate income tax law we shall provide a brief explanation of our tax rules. It is important to note that the lack of internal court decisions on non-discrimination, is in fact a consequence of a general crisis in our judicial system.[5]

The Portuguese income tax system results from the tax reform of 1988, whereby individuals are subject to an income tax regulated in the Personal Income Tax Code (hereafter PITC) Code and companies to a corporate tax regulated in the Corporate Income Tax Code (hereafter CITC). This reform was a constitutional demand as the Portuguese Constitution of 1976 states that individuals must be subject to a comprehensive progressive income tax. The previous system was composed of several codes taxing isolated items of income according to different progressive and proportional rates.[6] The new income tax code takes into account global income and subjects it to a progressive rate, but uses the technique of isolating items of income in order to determine the net income. Thus,

[1] Carlos Loureiro, 'A Tributação de não residentes: impacto da reforma fiscal', *Fisco*, 1988, n. 3, pp. 7 et seq.; Luís Oliveira, 'Tributação de títulos de entidades não-residentes', *Fisco*, 1990, n. 18, pp. 5 et seq.

[2] As was argued in the *Reyners* case (ECJ 21 June 1974, C-2/74).

[3] See Brigitte Knobbe-Keuk, 'Restrictions on the fundamental freedoms enshrined in the EC Treaty by discrimination tax provisions', *EC Tax Review* 1994/3, pp. 76-77; Josepf Schuch, 'Most favoured nation clause in tax treaty law', *European Taxation* 1994, p. 161; Kees Van Raad, 'The Impact of the EC Treaty's fundamental freedoms provisions on EU member states' taxation in border-crossing situations - current state of affairs', *European Taxation* 1995, pp. 192-193.

[4] See, for example, ECJ 28 January 1986, *Commission/France*, C-270/83; ECJ 8 May 1990, *Biehl*, C-175/88; ECJ 14 February 1995, *Schumacker*, C-279/93; ECJ 11 August 1995, *Wielockx*, C-80/94. See Brigitte Knobbe-Keuk, 'Restrictions on the fundamental freedoms enshrined in the EC Treaty by discrimination tax provisions', *EC Tax Review* 1994/3, pp. 76-77; Josepf Schuch, 'Most favoured nation clause in tax treaty law', *European Taxation* 1994, p. 161.

[5] Until now we have had notice of one Court decision about the issue of non-discrimination: Tribunal Tributário de 1ª instância do Porto, proc. imp. 215/94, 2.º juízo, 1:ªa secção.

[6] Paulo Pitta E. Cunha, *A Reforma fiscal* (Lisboa, 1989), pp. 14 et seq.

income of taxpayers is taxed according to different categories: income of dependent workers, income of independent workers, commercial, industrial and agricultural income, capital income, real estate income, capital gains, pension income and gambling income, which are subject to specific deductions. Residents are allowed to further deduct personal expenses such as expenses on health, education, insurance, trade union contributions, payment of interest resulting from bank borrowing designated to the buying of a dwelling house. Both Codes differentiate between taxation of residents and non-residents, and while the former are subject to a worldwide income tax with progressive rates, the latter are taxed on their source income at final withholding tax rates. There is only one category of non-resident taxpayer. Thus, non-resident taxpayers who receive most of their income within Portugal are not treated as residents, contrary to what was suggested by the EC Commission's Recommendation of 21 December 1993.[7]

Resident companies are taxed on their worldwide net profit at a proportional rate while non-resident companies are subject to a proportional tax in respect of income obtained within the Portuguese territory. However, non-resident companies are either taxed under a regime similar to that of residents if they operate in the Portuguese territory through a permanent establishment, as the income is taxed following the regime of profit assessment of resident companies, or to a final withholding tax according to certain categories referred to in the CITC - isolated treatment - except in the case of real estate income which is withheld on account and capital gains which are taxed by self-assessment.[8]

When resident companies exercise an indirect activity abroad, through affiliated enterprises, their profit is taxed under the condition of being transferred to Portugal, as in most tax systems. International double taxation is eliminated or alleviated by deduction of the lowest amount, either income tax paid abroad or the part of Portuguese corporate income tax, calculated before the deduction, corresponding to the income that may be taxed abroad (Art. 73).

2. Company taxation, freedom of establishment, freedom of supply of services and free movement of capital

2.1. Elimination of economic double taxation and international double taxation

Article 45 CITC regulates elimination of economic double taxation of resident companies. To the effect of determining the taxable profit of resident companies (trading companies, civil companies under commercial form, cooperatives and public enterprises) an amount of 95 per cent of taxable income corresponding to distributed profits by resident entities taxable and not exempted under CIT or under gambling tax, will be deducted, if the taxable company has a participation in the capital of the other company of no less than 25 per cent and for a consecutive period of two years or since the constitution of the participated entity during two consecutive years. Risk capital companies, regional developing companies and entrepreneurial promotion companies are not subject to the aforementioned conditions but still have to be residents, according to para. 2. By way of exception, 'general agencies of foreign insurance companies' are subject to the regime of deduction, in the same conditions as companies mentioned in para. 2. 'Foreign' means non-resident for purposes of the CITC.

After 1 January 1992, as a consequence of the harmonizing EEC/435/90 Directive, this regime of elimination of double taxation has been extended to resident entities that have a participation under the aforementioned conditions, in resident entities in another Community Member State, as long as the conditions of Art. 2 of the Directive are fulfilled: the credit is also granted to resident parent companies that receive dividends from an affiliate resident in another Member State.[9]

Other situations of economic double taxation of companies as long as they are resident in Portuguese territory are regulated by another rule, which provides a credit of 60 per cent of corporate income tax corresponding to distributed profits included in the taxable base (Art. 72).[10]

International double taxation has been unilaterally mitigated since 1993; a credit being given if income obtained abroad is included in the taxable base, and this credit corresponds to the lowest amount resulting either from income tax paid abroad or that part of corporate income tax, calculated before deduction, corresponding to income that may be taxed in Portugal (Art. 73).

If the first solution is applied - deduction of income tax paid abroad - it may happen that the amount is less than 95 per cent. The tax rule is therefore discriminatory in the case of companies resident in the European Community, not included in the regime of Art. 45. Thus, despite the rules that concern elimination of economic double taxation of Portuguese parent companies and affiliates resident in another Member State and elimination of international double taxation, both discrimination of foreigners and freedom of establishment are still violated, in view of the fact that only if the parent company is resident in Portugal and the affiliate resident in another Member State, the elimination of the double taxation rule will certainly apply in a non-discriminatory way.

7 Recommendation 94/79/EEC, OJ, L39/22.

8 Alberto Xavier, *Direito Internacional Tributário* (Coimbra), 1993, p. 355; F. e Nuno Pinto Fernandes, *CIRC Comentado e Anotado* (Lisboa, 1994), p. 578.

9 About implementation of EEC/435/90 Directive in Portugal, see, Francisco De Sousa Da Câmara, 'O Regime fiscal comum aplicável às sociedades-mães e sociedades afiliadas de diferentes Estados membros da Comunidade Europeia', *Fisco*, 1992, nos. 43/44, pp. 40 et seq.

10 See in José Carlos Gomes Dos Santos, 'Atenuação da dupla tributação económica ou benefício fiscal?', *Fisco*, 1990, n. 23, pp. 3 et seq., some questions raised by application of this rule.

In fact, permanent establishments located in Portugal belonging to companies resident in another Member State that receive dividends from a resident company (an affiliate) may not deduct these profits under the elimination of economic double taxation rule nor under the elimination of international double taxation rule as all the profits are obtained in Portugal. Different treatment in respect of elimination of economic double taxation against permanent establishments of non-resident companies, was considered discriminatory in the *Avoir fiscal* case, as the ECJ took into account that freedom of establishment (and the option of establishment) could not be dependent upon internal tax law, even in the absence of a community harmonized system.[11] In effect, as the reader may remember, the ECJ held the credit attributed to resident companies, including to affiliates of non-resident companies, had to be extended to permanent establishments situated within the territory. The argument invoked by the Court, that the French regime was more notably discriminatory because France had a source taxation and not a worldwide one,[12] does not apply to the Portuguese law. Nevertheless, worldwide taxation does not legitimize a different treatment of permanent establishments.[13]

Similarly to the previous French regime, Portuguese tax law does allow that resident companies, affiliates of non-resident parent companies, deduct dividends received by this company. But, as the permitted amount of deduction may be lower than 95 per cent, as we noticed, the correspondent rule (Art. 73 CITC) violates the non-discrimination principle. Besides, the resident affiliate may not deduct dividends distributed by a permanent establishment of a non-resident company located in the Portuguese territory, as at least, the parent company must be resident in Portugal, which is discriminatory and again violates freedom of establishment. These cases are not treated under Directive EEC/90/435, however the absence of harmonization is not an excuse for discriminatory regimes, as has been the jurisprudence of the ECJ.[14]

Article 58 EC Treaty provides that primary investment and secondary investment through an affiliate or a subsidiary may not be discriminated, thus, we may say it follows from Art. 58 that juridical form of investing in a country may not imply a different tax treatment if the economic link with the country is similar - which happens in the case of affiliates and subsidiaries.[15] However, there is a strong argument against these conclusions as it may be defended that there is no discriminatory treatment in the above-mentioned cases.

In fact, Art. 5, para. 4 of EEC/90/435 Directive admits that Portugal may collect a source tax on profits distributed by resident affiliated companies to their parent companies resident in another Member State until eight years after entry into force of the Directive; after this period of time, the council will decide unanimously about an eventual extension of the rule. It should be noted however, that underlying the exceptional regime is the concern of not losing tax revenues.

The issue is whether, due to this exception, granting of credit in non-harmonized situations is not required from Portugal. But this argument is contradicted by a rule in the Portuguese Tax Benefits Statute, repealed in 1993, according to which resident companies with permanent establishments and/or affiliates abroad would only be taxed at a beneficial rate (Art. 30-C).[16] The application of this rule was dependent on its being cemented by a government decree law, that was never enacted, but the example shows how incoherent the tax system is. In any case, we have doubts that the ECJ would accept the mentioned approach, as not even the *coherence of the applicable tax regime* argument used in the *Bachmann* case is helpful.[17]

2.2. Anti-abuse clauses

2.2.1. *Taxation of consolidated profit*

Taxation of the consolidated profit of a group of companies is only admitted, among other conditions, when all the companies belonging to the group have their head office or effective management in the Portuguese territory. As long as the EEC/90/435 Convention among Member States adopts the separate account method for determination of profits of associate companies resident in different Member States, in order to avoid international double taxation, the Portuguese regime is consistent with the community option, even though associated companies resident in different Member States will be in tax disadvantage in relation to resident associated companies. There are also strong anti-avoidance arguments that may be a valid reason for such a rule.

11 ECJ 28 January 1986, *Commission/France*, C-270/83.

12 This reasoning was considered very relevant: cf: Bruno Gouthière, 'Removal of discrimination - a never-ending story', *European Taxation* 1994, p. 300.

13 In fact, the UK also applies a worldwide corporate income tax and yet, the ECJ decided in the *Commerzbank* case, that permanent establishments had to be treated as resident companies: ECJ 13 July 1993, *Commerzbank*, C-330/91.

14 For example, ECJ 28 January 1986, *Commission/France*, C-270/83; ECJ 13 July 1993, *Commerzbank*, C-330/91.

15 M.A. Wisselink, 'Concepts of international tax avoidance: general', in *International Tax Avoidance* (General), 1978, pp. 54 et seq.; in this sense, Art. 24, n. 4 of the OECD Model Convention (Modèle de Convention Fiscale), Commentaires, C-(24)-20; and Kees Van Raad, *Issues in the application of tax treaty non-discrimination clauses* (BIFD 1988), pp. 348-349. Besides, refusal to attribute a credit to non-residents is clearly discriminatory if you compare this regime of credit with other regimes of alleviating double taxation. The split-rate system is applied to every beneficiary of distributed dividends, resident and non-resident: J. Van Hoorn Jr., 'Différences dans le traitement fiscal reservé aux investisseurs nationaux et étrangers et répercussions des traités internationaux', in *Cahiers de Droit Fiscal International* (1978, 53 b), p. 29; Bruno Gouthière, op. cit., n. 12, p. 301. Again reference should be made to ECJ 13 July 1993, *Commerzbank*, C-330/91.

16 Cf. Maria Teresa Veiga Faria, *Estatuto dos Benefícios Fiscais, Nota explicativa* (Lisboa, 1995), pp. 160-161: according to the author, this tax benefit was created to promote and facilitate internationalization of Portuguese enterprises abroad.

17 Cf. ECJ 28 January 1992, *Bachmann*, C-204/90.

2.2.2. *Resident entities in countries with a privileged tax regime*

There are some other anti-abuse clauses that are justified although they may act to restrict free movement of persons and capital. For example, payments to resident entities in countries with a privileged tax regime may not be deducted in order to determine taxable profit, unless the taxable company is able to prove that those payments correspond to 'genuine operations carried out' and do not have an abnormal character or are not of an excessive amount.

Another example is the direct imputation of profits to the resident partners independently of their distribution, when these profits are obtained by non-resident companies subject to a 'clearly more favourable regime' (rate lower than 20 per cent) provided that the resident partner directly or indirectly has a minimum holding of 25 per cent, or 10 per cent if over 50 per cent of the non-resident company is directly or indirectly held by resident partners.[18] A deduction of the corporate income tax paid in the state with a 'clearly more favourable regime' is stipulated. This rule implies non-granting of credit to the resident parent company that receives dividends from the affiliate resident in another Member State (if this state has a 'clearly more favourable system'), in contradiction with what is established by EEC/90/435 Directive. The Directive contains no general clause which provides for the non-application of the harmonized system in case of tax avoidance. However, the ECJ allows Member States to control tax avoidance (*Direct Cosmetics* case[19]), even if sometimes it has admitted this in an indirect way. In the *Daily Mail* decision, for example, the ECJ decided that, in the absence of Community harmonization, the transfer of domicile of companies might be subject to an authorization of British tax authorities trying to control transfers for tax-avoidance purposes.[20] Anti-abuse clauses must of course be recognized as not incompatible with community law, as long as they do not constitute a hidden instrument of discrimination.

2.2.3. *Restriction to payments of income to non-residents*

Article 106 CITC states that income of non-resident entities obtained within the Portuguese territory subject to corporate income tax may not be transferred abroad unless payment of due tax is demonstrated or its future payment is assured.

In the case of final withholding taxes this rule is not discriminatory. However, permanent establishments of non-resident companies are subject to three payments on account in July, September and December or in the 7th, 9th or 12th month of the respective period of taxation and must declare their income until 31 May. In our view, this rule is an obstacle both to free movement of persons and capital, and we may here invoke the *Luigi Brugnoni* decision.[21]

2.3. A too broad definition of source

As already mentioned, taxable profit of permanent establishments of non-resident companies is determined by the same rules applicable to resident companies and profits not attributed to permanent establishments obtained by non-resident entities are determined according to the rules of the PITC.

The problem in this case is whether a too broad concept of source is compatible with non-discrimination and free movement of services. In the first place, the CITC contains a too broad concept of permanent establishment. Article 4, para. 7 CITC stipulates there is a permanent establishment when a non-resident entity exercises its activity in Portuguese territory through employees or other persons engaged to the effect for a period not less than 120 days, with or without interruptions, during a period of 12 months.[22] Thus, there is neither a fixed establishment or sufficient connection between an establishment and a geographical place, nor a certain degree of permanence, as demanded by the OECD Model Convention.[23] It should be clarified that this rule is based on Art. 5, para. 3 of the UN Model Convention: 'The furnishing of services, including consulting services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve-month period'. There is no doubt that in both rules there exists the intention of capital importing countries taxing income of non-residents, but it is uncertain if such a rule does not contradict free movement of services in the European Community.

More serious in this respect is the additional taxation of non-resident companies with no permanent establishment in Portugal, which according to International Public Law, is justified if there is a sufficient connection between the taxpayer and the taxing state, and although there is no prohibition of international double taxation,[24] the question arises whether Community principles of non-discrimination and free movement of services are violated by too broad concepts of source and/or residence.

If there is no direct discrimination between nationals and foreigners in this respect, there is no economic connecting element that legitimates taxation.

[18] There are some companies that are not subject to this regime.

[19] ECJ 12 July 1988, *Direct Cosmetics*, C-138 and 139/86.

[20] ECJ 27 September 1988, *Daily Mail*, C-81/87.

[21] In this case, it was asked if discriminatory internal rules on capital movement were forbidden by Art. 67, n. 1 EC Treaty. The buying of assets negotiated in the stock exchange had been liberalized and Italy benefited from an exceptional regime granted by the Commission, according to which it might not give interest to foreign securities. It was demanded whether the obligation of depositing these securities was against free movement. The decision awarded by the ECJ was that the rule was against free movement of capital.

[22] See, about the concept of permanent establishment in Portuguese corporate tax legislation, Beja Neves, *O Conceito de estabelecimento estável* (Fisco, 1991), n. 29, pp. 35 et seq.

[23] Modèle de Convention de l'OCDE, C(5)-2 e 3.

[24] Klaus Vogel, *DBA - Doppelbesteuerungsabkommen Kommentar* (München, 1996), pp. 95-96.

Taking this view, we come to the conclusion that free movement of services is violated by the mentioned rule, as the tax element is an obstacle to it. The difficulty of judging the situation as discriminatory apparently lies in the absence of a comparative basis between nationals and foreigners.

In tax law, the discrimination question arises in respect of residents and non-residents and not in relation to nationals and foreigners, even though the ECJ often addresses an 'indirect discrimination' in respect of nationality (which is the one directly mentioned by the Treaty). Furthermore, internal tax rules may often prove restrictive to free movement, and accordingly, the ECJ invokes this argument to justify internal law violation of non-discrimination in respect of nationality.[25]

A special reference must be made to the *Wielockx* decision, whereby the ECJ defines discrimination as the application of different rules to comparable situations or the application of the same rule to different situations. The absence of a permanent establishment means a substantially different situation among non-resident companies without a permanent establishment, permanent establishments of non-resident companies and resident companies. The first situation does not legitimate taxation as recognized by the OECD Model Convention (Art. 7, para. 1 OECD Model Convention).

In our view, there is discriminatory treatment in respect of taxation of non-resident companies with no permanent establishment. And if freedom of establishment may not be penalized by taxes neither may freedom of supply of services be restricted by tax rules.

2.4. Investment tax deductions

As already mentioned, permanent establishments of non-resident companies are subject to a process of determining taxable profit similar to that of resident companies. They are allowed to make the same deductions as resident companies, and to further deduct as costs the general administration expenses attributable to the permanent establishment provided a criterion of allocation of these expenses is adopted, the limits are accepted as reasonable by the tax authorities and the criterion is justified and observed in the financial years following. The problem of discrimination arises, in the author's opinion, in respect of royalties of non-resident companies not attributable to a permanent establishment, as they may not deduct any costs according to Art. 15, n. 1 d) CITC. This results from the fact that they are not taxed on their profit (net result of the exercise and of variation of patrimony) but in an isolated way, as there is no permanent establishment. The underlying problem is precisely the taking into consideration of activities that should not be taxed under corporate income tax.

2.5. Taxation of transfer of assets

Article 36-A PITC, which was introduced in October 1995, also contains a discriminatory rule: realization of company capital, resulting from the transfer of all the assets affected to the exercise of a commercial, industrial or agricultural activity by an individual, as long as, among other conditions, the entity to which the assets are transmitted is a company with its head office status or effective management in Portuguese territory, is not taxed. Besides, according to Art. 68-A CITC, tax losses connected with the exercise of a commercial, industrial or agricultural activity before transfer of assets, and still not deducted, may be deducted from the profits of the new company until a certain period and up to a certain amount.

2.6. Personal deductions for taxpayers, free movement of services and free movement of capital

Another question of discrimination arises in the case of taxpayers' insurance payments, as the respective deductions are subject to the condition that the beneficiary entities are resident or have a permanent establishment in Portugal. As the reader may notice, this is a rule similar to the Belgian regime analyzed under the *Bachmann* case, although deductions are admitted if the beneficiary entities have a permanent establishment in the Portuguese territory. Some of the criticism directed at the Court decision in the *Bachmann*[26] case is valid in respect of the Portuguese legislation. For example, the coherence argument may not be invoked as double taxation agreements preclude the internal law 'coherence'. Moreover, the differentiation of treatment regarding non-resident companies with no permanent establishment would only be justified if we consider this is a cost-benefit-type rule, allowing the deduction admitted in the expectation of taxing the sums paid by the insurance enterprises.

However, as we understand these deductions to be personal deductions and therefore included in the relevant elements of determining the taxable base, tax treatment may not be different if the amounts are designated for non-residents without a permanent establishment in Portugal.[27]

2.7. Discriminatory rates

Non-resident companies that do not operate through a permanent establishment are taxed by final withholding rates that vary according to different categories. For example, royalties from the use and right

[25] For example, in the *Stanton/Inasti* case, the ECJ stressed that the right to maintain several centres of activity would not be disrespected if it would be refused a payment of a Social Security contribution by the state where the individual supplied services through a permanent establishment, which was not demanded from resident independent workers exercising their dependent work in that state: ECJ 7 July 1988, *Stanton-Inasti*, C-43/87. In any case, the Court compared the situation between residents and non-residents.

[26] See, P. Hinnekens, 'Impact of non-discrimination principle under EC Treaty in Belgian income tax law', *European Taxation* 1996, pp. 2, 61.

[27] Ana Paula Dourado, *Fisco*, 1993, no. 59/60, p. 76.

to use agricultural, industrial, commercial or scientific equipment are taxed at a rate of 15 per cent, while distributed dividends of resident affiliates of parent companies resident in another Member State are taxed at 10 per cent until 1999, debt equity and other capital income except profits distributed to entities subject to CIT are taxed at 20 per cent, gambling income is taxed at 35 per cent and all other income is taxed at a rate of 25 per cent. This differentiation of rates can hardly be explained and was the object of severe criticism by Professor Alberto Xavier who classified it as irrational and arbitrary.[28]

From a Community law viewpoint, and taking into account that a rate of 36 per cent is applied to the global net result of resident companies and permanent establishments of non-resident companies, the fact that the mentioned rates are applied in relation to final withholding taxes and differ without justification, is discriminatory in terms of capital investment and thus restricts freedom of supply of services and free movement of capital.

3. Free movement of employees and self-employed individuals within the European Community

3.1. Deductions from global net income and non-residents in a situation similar to that of residents

Resident taxpayers are subject to a worldwide income tax, while non-residents are taxed on their source income. Employees and self-employed individuals may deduct from their gross income a certain amount (65 per cent of income with a limit of 465,000 PTE), which might be higher if the obligatory contributions to social security exceed this limit, and/or in the event of a permanent handicap equal to at least 60 per cent. The taxable gross income of independent workers is subject to deduction of a list of costs when connected with the professional activity. These deductions designed to determine the net income are applicable both to resident and non-resident taxpayers' income.

In the case of deductions connected with donations of public interest (donations to administration, foundations, churches, museums, libraries, schools, etc.), there is no differentiation between residents and non-residents. However, deductions from global net income are only admitted in the case of residents, where such expenses relate to health, education, old peoples' homes, interest and amortization of debt contracted in order to buy, construct or improve a dwelling house, life insurance premiums in certain conditions (risks of life, invalidity or old age retirement, in this case as long as the benefit is assured after the age of 55 and five years of insurance), as well as illness or personal accidents insurance premiums, and contributions to funds of pensions or other complementary regimes of social security, relating to the taxpayer or others, paid by him or third persons if, in this case, they have been subject to personal income tax; indemnity resulting from unilateral termination of a labour contract; the amounts spent in acquisition of new equipment for the use of renewable energy sources if they cannot be considered costs according to other categories (independent workers, commercial income or agricultural income) and other amounts paid to trade unions. Furthermore, Art. 55 stipulates different limits to the amount of deductions according to the mentioned categories.

We must distinguish under the above rule the subject-related deductions (such as deductions on health, education and eventually life insurance costs), and deductions that constitute a tax benefit, like acquisition of new equipment for the use of renewable energy sources. After distinguishing the different nature of these deductions, we must then analyze their discriminatory character.

In terms of personal tax relief, the justification for restricting it to residents was traditionally explained by the argument that resident states are in the right position to tax according to that principle.[29] However, more relevant here is the quite recent discussion in the EC on taxation of another category of non-resident taxpayers (which led to new tax rules in some Member States): those who have the preponderant part of their income in the Member State of activity.[30]

Both the Commission's recommendation on this matter, as well as ECJ decisions have to be considered in this respect. If the possibility of personal deductions does not exactly correspond to the *Biehl* case, we may still apply the reasoning of the ECJ to non-residents that earn most of their income in the Member State of activity. In 1980, the Commission also proposed that deductions to the taxable income of workers in the EC, or of payments made to (among others) insurance companies, banks, and pension funds, could not be refused due to the fact that the beneficiary of the payments resides in another Member State.

Finally, in the *Schumacker* and *Wielockx* decisions, the Court ruled that a non-resident taxpayer who receives the major part of his income from the source state, is objectively in the same situation as a resident taxpayer engaged in a comparable activity. On the other hand, deductions from interest income derived from a loan for home improvements or for buying a dwelling house, as well as deductions to payments of new equipment for the use of renewable energy sources are tax benefits. In fact, these rules have non-fiscal aims.

In order to conclude whether these rules are substantially discriminatory or not, it must be determined whether the aim of the tax benefit is assured in case of equal treatment of residents and non-residents. In the first example, in our opinion, the object is to stimulate acquisition of an owner occupied home, and therefore it is not discriminatory to restrict

[28] Alberto Xavier, *Direito Tributário Internacional* (Coimbra, 1993), pp. 373-375.

[29] We can still find this reasoning in the jurisprudence of the ECJ: see ECJ 14 February 1995, *Schumacker*, C-279/93; ECJ 11 August 1995, *Wielockx*, C-80/94.

[30] Cf. P. Hinnekens, op. cit., p. 57; Bruno Gouthière, op. cit., n. 12, p. 298.

this tax benefit to residents. In the *Tither* decision only the residents not exempted from income tax could benefit from a similar regime,[31] this option of limiting tax benefits to the residents from whom the state obtains tax revenues, may be justified as a cost-benefit rule, or as a means of rationalizing tax expenditure. The same argument might be applied in the case of the Portuguese law.

In the second example, on the contrary, the purpose of the tax benefit is not limited to residents and should be applied to non-residents whose activity within the Portuguese territory would justify the acquisition of such equipment: the second example reveals an object-related tax benefit. In a different sense we may argue that the concept of resident is so broad in Portuguese tax legislation that, in most situations, the acquisition of the referred equipment is connected with the exercise of an activity in Portugal by residents. It is clear that the possibility of personal deductions would moreover require taxation at a progressive rate and refusal of final withholding taxes.

3.2. Personal and family situation

Non-resident taxpayers are always taxed according to the rules applicable to single, widow, divorced or judicially separated individuals, independently of their personal and family situation (Art. 15, para. 2 PITC). This regime is discriminatory as some of its rules are less favourable than the ones applicable to married taxpayers. In fact, Art. 80 provides for a special deduction from the taxable amount which benefits married taxpayers, as both individuals may deduct an amount that is globally higher than the deductible amount of the single taxpayer and the rates applicable to resident married taxpayers are more favourable than those applicable to other resident taxpayers.

Again we may argue that if consideration of a family situation should as a rule be made by the state of residence, non-residents that obtain most of their income in Portugal should be treated as residents.

3.3. Too broad concepts of residence and source

Our PITC contains a very broad definition of residence: namely, residents are those who stay in the territory more than 183 days, with or without interruption, and those who, having stayed less time, keep a dwelling place in such condition that it may be considered there is a intention of keeping and occupying it as an habitual abode. Besides, persons belonging to the household are always treated as residents if any one of the persons resides in Portugal.

This means that if individuals are taxed as residents due to the above-mentioned criteria, even if apparently being subject to some more favourable aspects than non-residents (such as deductions, progressive rate, etc.), they might be taxed on their worldwide income in more than one state.

Once again the argument used in the *Wielockx* decision is relevant: discrimination consists of the application of different rules to comparable situations or in the application of the same rule to different situations. A person belonging to the family unit living more than 183 days outside Portugal is not in the same circumstances as the taxpayer who lives in Portugal more than 183 days. As taxpayers who are under substantially different circumstances should not be treated in the same way, this common treatment gives rise to distorting effects and restricts free movement of persons.

Under the concept of source, Art. 17 includes capital income paid by resident companies or by permanent establishment of non-resident companies, to resident individuals on behalf of non-resident entities which do not have a permanent establishment to which payment may be imputed, as well as capital income situated in Portuguese territory by virtue of acts or whose refund is guaranteed with goods within the territory unless otherwise proved. This rule has been very much criticized by the doctrine, as it taxes income having no relevant connection with the Portuguese territory (like interest of a security negotiated in Portugal between two non-resident entities).[32] It is clearly a discriminatory rule.

3.4. Withholding taxes

Withholding tax rules also provide for a discriminatory regime. In Portugal the withholding tax regime is very broad, but residents are, in most situations, allowed to opt for the inclusion of income subject to withholding in the global income, if they are owed by entities with head office, domicile, effective management or permanent establishment in Portugal, and as long as the income is not obtained pursuant to the exercise of commercial, industrial or agricultural activities, for the purpose of calculating the progressive rate (Art. 74, para. 6 CIRS). In contrast, non-residents may not opt for this regime, if they are subject to a final withholding tax and not to progressive rates. Moreover, rates in the case of withholding tax, are applicable to gross income, except in respect of pensions. Article 80, para. 1 still provides, after the amount of tax being determined, for a certain deduction from the amount of personal income tax, which depends on the family status, and is only applied to resident taxpayers.

Distribution of dividends to resident individuals by resident companies as well as capital income resulting from corporate distribution upon liquidation of resident companies will be granted an amount of 60 per cent of corporate income tax subject to certain limits (Art. 80, paras. 3 and 7 PITC). Adapting the reasoning used in the *Avoir fiscal* case to individuals, it is very obvious that this regime is discriminatory and restricts both free movement of workers and freedom of establishment. In other words, we may notice that international double taxation is not unilaterally attenuated in the case of personal income tax. However, deductions from real estate income seem

[31] ECJ, 22 March 1990, *Tither*, C-333/88.

[32] Luis Oliveira, *Tributação de títulos de entidades não residentes* (Fisco, 1990), n. 18, pp. 5–6.

to be applied both to residents and non-residents, as para. 2 of Art. 80 makes no distinction.

4. Conclusion

From the previous analysis it can be concluded that there are several discriminatory rules in the Portuguese income tax law. The tax reform of 1988 was not very conscious of EC law principles of non-discrimination and free movement. On the contrary, there was a clear intention of taxing imported investment almost under any circumstances, and subsequent alterations have had no relation with the aforementioned Community law principles. Thus, income tax rules differentiate between resident and non-resident categories, no reference being made to non-residents who receive most of their earnings in Portugal. There are also very broad concepts of resident taxpayers in the PITC and of source in both income tax codes.

The method of elimination of economic double taxation, as well as some anti-abuse clauses and some cases of investment tax deductions is discriminatory. Personal tax deductions are not extended to non-residents and tax rates may be discriminatory as non-residents are taxed according to final withholding taxes. Another noteworthy fact is the lack of court decisions about non-discrimination issues. The impact of EC law only occurred in respect of the directives harmonizing the Portuguese regime.

The Denkavit–Vitic–Voormeer case[1]

Judgment of the European Court of Justice of 17 October 1996 and its consequences for some anti-abuse provisions introduced in Member States' legislation implementing the Merger Directive (90/434/EEC) and Parent-Subsidiary Directive (90/435/EEC)

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1. Introduction

The Parent-Subsidiary Directive (90/435/EEC) of 23 July 1990[3] which entered into force on 1 January 1992 provides for a comprehensive tax relief in the European Community for profits distributions between subsidiaries and parent companies of different Member States.

The Directive eliminates double taxation on such profits distributions by exempting these distributions from withholding tax levied in the Member State of the subsidiary (Art. 5 of the Directive) and by obliging the Member State of the parent company to grant either tax exemption for the profits distribution from a subsidiary of another Member State, or a tax credit for the corporation tax paid by the subsidiary which relates to those profits (Art. 4 of the Directive).

Article 3 of the Directive defines the notion of parent company and subsidiary. A parent-subsidiary relationship exists at least when the parent company has a holding of 25 per cent in the capital of a company of another Member State, which then becomes its subsidiary. The criterion of a holding in the capital can be replaced by a criterion of a holding in the voting rights.

In order to avoid a situation where the privileged tax treatment might be abused through an acquisition or subscription of the shares in the subsidiary and a quick resale shortly after the distribution of profits, the Directive provides in Art. 3(2) second indent, an option for Member States not to apply the Directive to companies which do not maintain for an uninterrupted period of at least two years the holdings giving them the quality of a parent company. This provision is very similar to the text of Art. 3(2) of the proposal for a Directive of 1969,[4] which stated:

> 'However, each Member State has the right not to apply the provisions of the present directive to corporations falling under its domestic law which do not retain for a period of at least two years a participation qualifying them as parent corporations'.

This provision was explained in the comments which indicated:

> 'The second question, i.e. the period during which such a participation must be held, is at present also subject to different treatment by the various States. Certain legal systems are very flexible, while, on the contrary, others are rather stricter in order to avoid a situation where the privileged treatment might be abused through the quick resale of the shares of subsidiaries which have been acquired or subscribed. It is for this reason that, without

[1] Joined cases C-283/94, C-291/94 and C-292/94.
[2] This article expresses the author's personal opinion and does not in any way commit the European Commission.
[3] OJ, L 225 of 20 August 1990.
[4] OJ, C 39 of 22 March 1969.