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Preface

The European Court of Justice (ECJ) has had to deal with more and more cases concerning direct taxation in the past years. This growing amount of case law is driven by the increased willingness of national courts to approach the ECJ through preliminary rulings as well as by the fact that the European Commission seems to be more and more willing to initiate infringement procedures against EU Member States. Furthermore, in addition to the provisions on the fundamental freedoms, the provisions on State aid have recently gained more relevance and have triggered additional case law pertinent to direct taxation. As all these cases are of great interest for academics as well as practitioners, they need to be analysed carefully.

The conference “Recent and Pending Cases at the ECJ on Direct Taxation” was held in Vienna from 29 November to 1 December 2012. A large number of experts on European and international tax law accepted our invitation to attend the conference and took part in the discussions. At the conference, cases in the field of direct taxation now pending before or recently decided by the ECJ were presented by experts of the respective countries. The cases involved interpretation issues on the fundamental freedoms, the directives as well as the provisions on State aid. The national reporters provided insights into the national as well as the European background of the cases. These presentations were the basis for further lively discussions among the international participants. Possible consequences of the pending cases, future ECJ decisions and future trends in the ECJ’s case law were discussed and analysed in detail. The results of the conference are published in this book.

The conference would not have been possible without the support of “PricewaterhouseCoopers” and the City of Vienna to whom we would like to express our thanks. In addition, we would like to warmly thank the authors who contributed to the conference by presenting cases from their countries and getting actively involved in the discussions. Furthermore, they supported the entire project and the publication of this book by committing themselves to a strict time schedule. We are also grateful to the Linde publishing house for its co-operation and the quick realization of the book’s publication. Linde has generously agreed to include this book in its catalogue.

Our particular thanks go to Renée Pestuka for the smooth organization of the conference, to Margaret Nettinga, who edited and polished the texts of the authors, and to Eline Huisman, who supported us in deciding on the structure of the conference and in the preparation and publication of this book.

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1. *Fazenda Pública v. Itelcar – Automóveis de Aluguer Lda* (C-282/12)

1.1. Facts of the case

Fazenda Pública v. Itelcar is a case on the Portuguese thin capitalization regime in force as amended after the *Lankhorst-Hohorst* case. According to this thin capitalization regime under the Corporate Income Tax Code (CIRC), interest payments by a taxpayer subject to corporate income tax to an entity that is neither a resident in Portuguese territory nor in an EU Member State and with which there is a special relationship may not be deducted from taxable income if these payments exceed at any date of the taxable period twice the share capital participation held by the non-resident company.

Every type of credit granted to the taxpayer is taken into account for the thin capitalization ratio and independently of the remuneration agreed and there is no reclassification of income. Moreover, it is possible for the taxpayer to prove that it would have obtained the same level of indebtedness and the same terms at arm's length – if it had not formed part of the same group of companies – taking into account the type of activity, its dimension, risks incurred by its activity at arm's length, the sector of activity in which the company operates. Transfer pricing documentation is also required in the proof procedure.

Itelcar was a Portuguese company and received loans from its parent company, GE Capital, a company resident in the USA. Itelcar was directly held by a company resident in an EU Member State which was in turn a subsidiary of GE Capital. Loans were directly granted to Itelcar by GE Capital. Following to an audit by the Tax Administration, Itelcar was considered to be thin capitalized in the fiscal years from 2004 through 2007 and that led to the application of the thin capitalization rule, non-deductibility of interest and an additional tax assessment. As mentioned above, the Portuguese thin capitalization regime allows the taxpayer to demonstrate that he would be able to obtain the same level of borrowing at arm's length, and in order to fulfil this requirement, Itelcar presented an independent bank estimate for granting a similar loan, as well as a study evidencing that an arm's length indebtedness within the taxpayer's industry was respected in its transfer pricing documentation.

However, the Portuguese tax administration considered the burden of proof was not fulfilled by the taxpayer. Itelcar filed an administrative claim followed by a judicial appeal, claiming that the tax assessments were illegal, on the grounds that they are incompatible with the free movement of capital: in other words, the thin capitalization rules were incompatible with Articles 63–65 TFEU in respect of indebtedness of Portuguese taxpayers to lenders resident in a third country.

The first instance court rejected the argument, considering that the situation was only covered by the freedom of establishment and, therefore, Member States were not prevented from applying thin capitalization rules to third countries. Itelcar appealed to the second instance (Tribunal Central Administrativo – Sul), which in

turn considered that both freedoms (the freedom of establishment and the free movement of capital) were applicable and referred the following question to the ECJ:

“Do Articles 63 and 65 TFEU preclude legislation of a Member State, such as that contained in para. 61 CIRC in the wording resulting from DL 198/2001, 3 July, as amended by Law 60 A/2005, 30 December, that does not allow the setting of interest relating to the part of its indebtedness regarded as excessive under para. 61 (3), with which it maintains special relations?”

1.2. The ECJ settled case law on thin capitalization rules and restrictions to the fundamental freedoms

Previous cases on thin capitalization rules – *Lankhorst-Hohorst*¹, *Thin Cap GLO*² and *Lasertec*³ – were considered to be cases on freedom of establishment. They constitute a group of cases where overlapping of free movement of capital and freedom of establishment occurs and where the Court considered that free movement of capital is purely an indirect consequence of freedom of establishment.⁴

This is due to the fact that in those cases the rules were applicable to situations involving groups of companies⁵ and the law referred to substantial holdings⁶; to loans made by a non-resident company to a resident subsidiary of which the former owned 75% of the capital or where both companies were 75% subsidiaries of a non-resident third company⁷; and, where double taxation conventions were applicable,

¹ ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*.

² ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland*.

³ ECJ 10 May 2007, C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v Finanzamt Emmendingen*.

⁴ On the overlapping between free movement of capital and other freedoms, see, for example: Sigrid Hemels, et al., *Freedom of Establishment or Free Movement of Capital: Is There an Order of Priority? Conflicting Visions of National Courts and the ECJ*, *EC Tax Review*, 2010/1, pp. 19–31; Daniel S. Smit, *The relationship between the free movement of capital and the other EC Treaty freedoms in third country relationships in the field of direct taxation: a question of exclusivity, parallelism or causality?*, *EC Tax Review*, 2007/6, pp. 252–267; Axel Cordewener et al., *Free movement of capital and Third Country: Exploring the outboundaries with Lasertec, A & B and Holböck*, *European Taxation*, 2007/8–9, pp. 371–376; *Free Movement of Capital between EU Member States and Third Countries: How Far Has The Door Been Closed?*, Ana Paula Dourado, ‘Portuguese report’, *The EU and Third Countries: Direct Taxation*, Michael Lang, Pasquale Pistone (eds.), Linde Verlag, Wien, pp. 499–536; Pasquale Pistone, *The Need for Clarity and the Application of the Acte Clair Doctrine to Direct Taxes*, *Intertax* 35, 2007/10, p. 536.

⁵ ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst*, para. 3; ECJ 10 May 2007, C-492/04, *Lasertec*, para. 4 and ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, paras 4–15.

⁶ ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst*, para. 3.

⁷ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 6.

interest would be deductible if the amount of interest corresponded to what would have been agreed at arm’s length between the parties or between the parties and a third party⁸; or according to some other double taxation conventions, deductibility of interest in those circumstances involves a more general enquiry into whether the amount of interest exceeds, for any reason, what would have been agreed at arm’s length between the parties or between the parties and a third party; and the enquiry implied answering the question whether the amount of the loan itself exceeds what would have been lent at arm’s length⁹; and to loans obtained by a company limited by shares to unlimited taxation from a shareholder not entitled to corporation tax credit which had a substantial holding in its share or nominal capital; a significant holding existed where the shareholder held directly or indirectly over one quarter of the share or nominal capital of the company limited by shares.¹⁰

In all three cases, the holding conferred the lesser a definite or dominant influence, a determinative influence, over the lessee¹¹ and the restrictive effects on free movement of capital were considered to be an unavoidable consequence of the restriction on freedom of establishment.¹² Moreover, in the *Thin Cap GLO* case the ECJ decided that Article 43 had no bearing in situations “*in which a resident company is granted a loan by a company which is resident in another Member State and which does not itself have a controlling shareholding in the borrowing company and where each of those companies is directly or indirectly controlled by a common parent company which is resident, for its part, in a non-member country*”¹³; and in situations in which both the lending company and the common parent company are resident in a non-member country, nor does it have any bearing on a situation in which a lending company which is resident in another Member State and does not itself control the borrowing company grants the loan through a branch established in a non-member country, where the common parent company is also resident in a non-member country.¹⁴

Thin capitalization rules therefore constitute a restriction to the freedom of establishment and in situations where a group of companies has affiliates in EU Member States and third countries; what matters is the residence of the controlling company, the “true parent”, as follows from paras. 95 and 98 of the *Thin Cap GLO*, or, in other words, which of the companies has influence on the funding decisions.¹⁵

⁸ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 7.

⁹ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 8.

¹⁰ ECJ 10 May 2007, C-492/04, *Lasertec*, para. 4.

¹¹ ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst*, paras. 20, 32; ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, paras. 28, 32; ECJ 10 May 2007, C-492/04, *Lasertec*, para. 22–23.

¹² ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 34; ECJ 10 May 2007, C-492/04, *Lasertec*, para. 25.

¹³ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 98.

¹⁴ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 100.

¹⁵ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 99.

If the latter is situated in an EU Member State, as well as the borrowing company, freedom of establishment will apply. If, in contrast, the borrowing company is a company of an EU Member State, but the lender is situated in a third country, any restriction is outside the scope of the TFEU: this is because third countries are only protected by the free movement of capital and the latter is not applicable, since it is understood as an unavoidable consequence of the freedom of establishment.¹⁶

We can also conclude that in case thin capitalization rules constitute a restriction to the freedom of establishment, an arm's length test will function as a test of objective artifice and may justify the restriction.¹⁷ Such legislation may then be justified by the need to combat abusive practices, and as long as the taxpayer is given the opportunity to provide evidence that the arm's length was achieved, without being subject to undue administrative constraints, the legislation will be considered to be proportional.

1.3. The Portuguese thin capitalization rules in light of the ECJ settled case law

The Portuguese thin capitalization regime applies to situations where the borrower is a resident taxpayer and has "special relationships" with a lender that is neither resident in the Portuguese territory nor in another EU Member State (Article 61 para. 1 CIRC¹⁸). "Special relationships" are deemed to exist between two entities when one has the power to exercise, directly or indirectly, significant influence over the management decisions of the other, which is considered to be the case, for example, between (Article 57 CC¹⁹):

- a) An entity and its shareholders, or the spouses, ascendants, or descendants of the latter who hold, directly or indirectly, an interest amounting to not less than 10 percent of the capital or voting rights;
- b) Entities in which the same shareholders, their respective spouses, ascendants, or descendants hold, directly or indirectly, an interest amounting to not less than 10 percent of the capital or voting rights;
- c) An entity and the members of its corporate bodies, or of any administrative, executive, managerial, or supervisory bodies, and their respective spouses, ascendants, and descendants;
- d) Entities in which the majority of the members of its corporate bodies or of the members of any administrative, executive, managerial, or supervisory bodies

¹⁶ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 101.

¹⁷ ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 80–82.

¹⁸ Currently, Article 67 para. 1 CIRC.

¹⁹ Currently, Article 63, para. 4 CIRC.

are the same persons or, if different, are related to one another by marriage, common law marriage, or direct kinship;

- e) Entities bound by a subordination, peer group, or other contract having the same effect;
- f) Entities that are in a situation of control, as this is defined in the legislation that establish the obligation to elaborate consolidated financial demonstrations;
- g) Entities between which, by virtue of commercial, financial, professional, or legal relationships with one another, whether directly or indirectly established or pursued, a situation of dependency exists in the exercise of the respective activity (and some examples are put forward by the law).

Taking into account the legal definition of "special relationships", and that the Portuguese thin capitalization rules apply in these cases, it has to be determined, first, if they constitute a restriction to the freedom of establishment, or whether they can also constitute a restriction to the free movement of capital, namely in cases such as the one that has been referred to the ECJ, where third countries are at stake.

In other words, it has to be determined whether "special relationships" always refer to situations falling under the criterion of definite influence that goes back to the *Baars* case²⁰, and as it has been decided in the aforementioned case law involving thin capitalization cases.

It is herein contended that the Portuguese legislation is applicable to cases where the lender has a definite influence on the borrower of the capital, similarly to the previous case decided by the ECJ on thin capitalization rules²¹. Because EEA States are not covered by the Portuguese thin capitalization regime, there is a restriction to the freedom of establishment and a discriminatory treatment against lenders of EEA States. Because the Mutual Assistance Directive is not applicable to the relations between EEA Member States, the arm's length test may justify the restriction to the freedom of establishment, even if its application implies costs that are not required of domestic and EU lenders²². As long as the EEA Member States exchange information with the Portuguese Republic, either under a bilateral tax treaty or under another international treaty that is equivalent to Article 26 of the OECD MC, the arm's length test will enable the taxpayer to prove that the loans are not abusive and that proof can be controlled by a bilateral exchange of information²³.

We can also ask, in a next step, whether the Portuguese legislation is also applicable to cases where the lender does not have a definite influence on the borrower of the capital. In this case, it has to be asked what the purpose of the legislation

²⁰ ECJ 13 April 2000, C-251/98, *Baars*.

²¹ Differently, Francisco de Sousa da Câmara/José Almeida Fernandes.

²² ECJ 15 May 1997, C-250/95, *Futura Participations SA and Singer v Administration des contributions*, paras. 36–41.

²³ ECJ 11 June 2011, C-521/07, *Commission v. Netherlands*, para. 47.

is²⁴, in order to correctly interpret the Portuguese regime in light of the fundamental freedoms. The answer should again be that the Portuguese thin capitalization regime is directed at covering cases involving control or definite influence and it has to be interpreted in that manner.

The arm's length test is an integral part of the thin capitalization regime and presupposes a comparison between a situation involving definite influence and a situation involving independent entities. If correctly applied, the arm's length test will allow the deduction of interest, in cases where there is no definite influence. This is in line both with the above-mentioned *Thin Cap GLO* case and also with the *SGI* case (the latter being a case applicable to the deductibility of expenses)²⁵. It has, however, to be demonstrated that the arm's length test is proportionate, not only as an anti-abuse test, but also in the sense that the taxpayer is granted the opportunity, without being subject to undue administrative constraints, to demonstrate a commercial justification for the arrangement.

In the case under analysis – *Fazenda Pública v Itelcar* – it is clear that Itelcar borrowed capital from a US lender GE Capital and is indirectly owned by it. It results from paras. 95–100 of the *Thin Cap GLO* case that the US GE Capital controls Itelcar, and this means that free movement of capital is only an indirect consequence of the freedom of establishment and is not applicable. The case therefore falls outside the scope of the TFEU.

1.4. Final remarks

The Portuguese Budget for 2013 includes a legislative authorization for the Government to introduce new rules regarding the deductibility of costs. According to this authorization, deductibility of costs with net financing is limited to EUR 3 000 000 or to 30% of the net result before depreciation, net financing expenses and taxes.

Non-deductible costs can be carried forward for a period of five years together with the financing costs of the corresponding fiscal year. If the amount of financing expenses is inferior to 30% in a given fiscal year, the non-used percentage is added to the 30% limit of the subsequent period for the maximum period of five years. In the case of associated enterprises, limits are calculated in respect of each company/permanent establishment of the group. Financial and insurance institutions are not covered.

²⁴ ECJ, 24 May 2007, C-157/05, *Holböck v FA Salzburg-Land*, paras. 22–24; ECJ 26 June 2008, C-284/06, *Finanzamt Hamburg-Am Tierpark v Burda GmbH, formerly Burda Verlagsbeteiligungen GmbH*, para. 71; ECJ 4 June 2009, joined cases C-439/07 and C-499/07, *Belgische Staat v KBC Bank NV*, and *Beleggen, Risicokapitaal, Beheer NV v Belgische Staat*, paras. 69–70; ECJ 18 June 2009, C-303/07, *Aberdeen Property Fininvest Alpha Oy* paras. 33–35; ECJ 17 September 2009, C-182/08, *Glaxo Wellcome GmbH & Co. KG v Finanzamt München II*, para. 47.

²⁵ ECJ, 21 January 2010, C-311/08, *Société de Gestion Industrielle SA (SGI) v État belge*, para. 71.

2. ECJ Case C-38/10 – *Commission v. Portuguese Republic*

2.1. Facts of the case

The facts underlying the infringement procedure regarding the compatibility with the EC Treaty/TFEU of exit taxes on companies under the Portuguese Corporate Income Tax Code, and the related comments, have already been published.²⁶

To remind the reader, the aforementioned infringement procedure concerns the case of the transfer of seat and place of effective management of a Portuguese company to another Member State where that company ceases its activity in the Portuguese territory, and non-realized capital gains at the time the activity ceases are relevant for determining the taxable profit. However, in case the assets and liabilities of the company that transferred its residence are part of a permanent establishment of that entity in the Portuguese territory, there will be no taxation. Taxation will also occur in case a permanent establishment ceases its activities in Portugal or transfers its Portuguese-located assets and liabilities to another Member State. Common to the two cases is the requirement that the activity effectively cease in the Portuguese territory: the taxable base of that fiscal year will include any unrealized capital gains in respect of the company's assets whereas unrealized capital gains from purely domestic transfer of assets are not included in the taxable base. Shareholders are also subject to tax on the difference between the company's net assets (valued at the time of the transfer at market prices) and the acquisition cost of their participation.

2.2. Restriction to the freedom of establishment and scope of the action

According to the European Commission, the described immediate taxation of unrealized capital gains penalizes those companies that wish to leave Portugal or to transfer assets abroad, as it results in less favourable treatment as compared to those companies which remain in the country or transfer assets domestically. Consequently, the Portuguese regime constituted a restriction to the freedom of establishment.

Following points 14–17 of the Opinion of the Advocate General Mengozzi on the case²⁷, the ECJ declared the action inadmissible in respect of an infringement of Article 31 of the EEA Agreement, because the letter of formal notice sent to the Portuguese Republic on 29 February 2008 did not contain any reference to an alleged infringement of Article 31 of the EEA Agreement.²⁸

²⁶ See Ana Paula Dourado, Portuguese recent and pending cases, in Lang et al. (ed.), *ECJ Recent Developments in Direct Taxation 2009*, Kluwer/Linde, Vienna, 2009. See also: Ana Paula Dourado/Pasquale Pistone, Looking beyond *Cartesio*: reconciliatory interpretation as a tool to remove tax obstacles on the exercise of the primary right of establishment by companies and other legal entities, *Intertax*, no. 5, 2009.

²⁷ Opinion of Advocate General Mengozzi, delivered on 28 June 2012, C-38/10, *European Commission v Portuguese Republic*.

²⁸ ECJ 6 September 2012, C-38/10, *Commission vs Portugal*, paras. 17–20.

Except for the mention, under the heading ‘facts’, of Article 76 C of the CIRC, the letter of formal notice did not include a separate complaint concerning taxation of the members of a Portuguese company transferring its registered office and effective management to another Member State. The action was also declared inadmissible in so far as it concerned this complaint.

2.3. The ECJ decision

In its judgment, the ECJ followed the reasoning of the *National Grid Indus* case²⁹: according to the ECJ, it follows from *National Grid Indus* that freedom of establishment is applicable to transfers of activities of a company from the Portuguese territory to another Member State, irrespective of whether the company in question transfers its registered office and its effective management outside the Portuguese territory or whether it (partially or totally) transfers assets of a permanent establishment that is situated in the Portuguese territory to another Member State.³⁰ According to the ECJ, Articles 76 A and 76 B of the CIRC entail obstacles to the freedom of establishment given that, in the case of transfer, by a Portuguese company, of its registered office and its effective management to another Member State and in the case of partial or total transfer to another Member State of the assets of a permanent establishment in the Portuguese territory of a company not resident in Portugal, such a company is penalized financially, compared with a similar company which maintains its activities in Portuguese territory which transfers assets in Portuguese territory.³¹

However, in contrast to the Advocate General’s Opinion³², the ECJ decided that the cessation of activity related to a Portuguese permanent establishment (Article 76 B(a) of the CIRC) did not entail a restriction on the freedom of establishment, because the treatment is not discriminatory. As the Portuguese Republic had pointed out, Article 43 of the CIRC also provides for a Portuguese company to be taxed on unrealized capital gains relating to assets detached from the company’s economic activity.

2.4. Justification and the justification’s proportionality

Following again *National Grid Indus*, the ECJ considered that Article 49 TFEU precludes immediate recovery of tax on unrealized capital gains relating to assets of a company transferring its place of effective management to another Member

²⁹ ECJ 29 November 2011, C-371/10, *National Grid Indus*.

³⁰ ECJ 6 September 2012, C-38/10, *Commission vs Portugal*, paras. 23.

³¹ ECJ 6 September 2012, C-38/10, *Commission vs Portugal*, paras. 27–29; See also the Opinion of Advocate General Mengozzi, delivered on 28 June 2012, C-38/10, *European Commission v Portuguese Republic*, paras. 55, 94–99 and 111.

³² Opinion of Advocate General Mengozzi, delivered on 28 June 2012, C-38/10, *European Commission v Portuguese Republic*, paras. 87–100.

State at the very time of that transfer.³³ However, if national legislation granted a choice to the company transferring its place of effective management to another Member State between immediate payment of the amount of tax and deferred payment of the amount of tax, even if the latter implies payment of interest, the measure would be proportionate.³⁴

2.5. Final remarks

It is very doubtful that a bank guarantee and the payment of interest are less restrictive than immediate taxation of unrealized capital gains, and the criticism directed to the *National Grid Indus* judgment in this respect is equally applicable to the *Commission v Portuguese Republic* case. The Court is not cautious enough in its assertions, when applying the proportionality test and it should revisit the topics on the bank guarantee and payment of interest when the next exit tax case is examined.

It seems clear, however, that the decision in *National Grid Indus* was not conditioned by the fact that a single financial asset was at stake, since the core issues were decided in *Commission v Portuguese Republic* in identical manner and the latter case was also applicable to a multiple assets situation.

We can add that it is now clear that (para. 112 of the) *Cartesio* case³⁵ operates in favour of Member States adopting the real seat theory as long as the incoming Member State does not allow conversion (and this is an internal market perspective); and it operates against Member States that do not adopt the real seat theory, because the regime in the incoming Member State is irrelevant and in this case the ECJ adopts a unilateral perspective.

And last but not least, the Portuguese Budget for 2013 also authorizes the government to enact new rules on the exit tax topic: the tax regime may foresee immediate payment of the tax due or in installments; the taxpayer will also be granted the option for deferred payment of tax; the decree-law may also create the possibility of interest payments and constitution of a guarantee in case the payment is deferred and the terms are also to be defined by decree-law; the decree-law will also establish related compliance obligations for the possibility of deferred payment of tax, such as identification of the assets covered by the deferred payment; the regime will be articulated with the mergers regime; and anti-abuse measures can be created.

³³ ECJ 29 November 2011, C-371/10, *National Grid Indus*, paras. 73, 86.

³⁴ ECJ 6 September 2012, C-38/10, *Commission vs Portugal*, paras. 31–32.

³⁵ ECJ 16 December 2008, C-210/06, *Cartesio Oktató és Szolgáltató bt*.