Portugal

Branch Reporters
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Summary and conclusions

Tax issues related to evasion, abuse and avoidance, at both a cross-border and purely domestic level, have recently been the focus of renewed attention from the Portuguese legislator, tax authorities and taxpayers. Although it has long been enshrined that taxpayers have the right to mitigate their tax liability by adopting the most tax efficient options that best suit their business interests, the adoption of some of the recent anti-abuse rules, and in particular their application by the tax authorities, may give rise to pertinent questions as to whether the line between abuse/avoidance and legitimate tax planning is being correctly drawn and applied in Portugal.

The Portuguese general anti-abuse rule (GAAR), introduced in 1999, was preceded in the mid-1990s by the introduction of specific anti-avoidance rules with an international focus, such as thin capitalization rules (1995), controlled foreign company (CFC) rules (1995) and a series of rules dealing with low-tax jurisdictions, namely blacklisted jurisdictions. After 1999, Portugal introduced, among other things, rules on exit tax (2006) and dividend stripping (2006), as well as a specific rule on abuse of its participation exemption regime (2005). However, the compatibility of such domestic anti-abuse rules (DAARs) with treaty law (and EC law) has not been subject to serious scrutiny by either the Portuguese authorities or the courts, since its specific application was very limited and it was mainly restricted to cases where blacklisted jurisdictions were involved (i.e. jurisdictions with which Portugal has not concluded tax treaties).

The broad conclusion of paragraph 9(2) OECD model convention (MC) commentary on article 1 that "as a general rule, there will be no conflict between such [anti-avoidance] rules and the provisions of tax conventions" does not seem to be fully upheld by the Portuguese legal system. In fact, as stated in the Portuguese observation in paragraph 27(8) OECD MC commentary on article 1, considering that the Portuguese Constitution has established a hierarchy where tax conventions prevail over domestic law if conflicts arise between a DAAR and a treaty, the DAAR will be deemed unlawful and hence inapplicable. Therefore, a possible application of a DAAR seems to be conditional upon the tax authorities' capacity,

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inter alia (depending on the specific DAAR they intend to apply), to evidence that (a) the main purpose of the transaction was to obtain a treaty benefit in a manner considered contrary to the purpose of the treaty itself; (b) the treaty itself would not restrict it (expressly or tacitly having narrower anti-avoidance provisions); and (c) the other contracting state agrees with the abuse being challenged by the use of the DAAR in question. In conclusion, in case of conflict, the tax authorities cannot apply the DAAR.

At a treaty level, the Portuguese negotiators did not generally raise the issue of the introduction of either general or specific anti-avoidance rules during the period between 1994 and 2003, when the majority of the Portuguese tax treaties were negotiated. The understanding of the hierarchy of the tax treaties over domestic law raised legal issues regarding the possibility of DAAR denying the entitlement to treaty benefits; the tax authorities had administrative problems in applying and enforcing some treaty concepts (e.g. beneficial ownership) and also had the express negotiating goal of having the preferential tax regimes of Madeira and Azores included within the scope of treaties, which led to the Portuguese negotiators refraining from proposing the introduction of anti-abuse provisions as a matter of treaty policy (although in some limited cases, Portugal was forced to agree to some rules in order to be able to conclude treaties with some major trading partners, such as the USA).

Furthermore, upon the publication of the OECD MC 2003 update and the introduction of an amendment to the commentary to article 1, Portugal expressed its concerns by introducing an observation to the revised commentary, which seemed to imply that Portugal would not allow the application of any DAAR if it could be said to be in conflict with the treaty provisions based on its understanding of the hierarchy of laws in the Portuguese legal system. Therefore, only recently has Portugal accepted the introduction of general (e.g. in the treaties with Estonia, Latvia, Lithuania and Moldova) or specific anti-abuse provisions. The specific provisions included in Portuguese tax treaties have mainly dealt with the limitation of entitlement to treaty benefits where residents are controlled by non-residents (e.g. the treaties with the USA, Spain, the Netherlands and Ukraine) and provisions allowing the taxation of gains arising from the alienation of shares deriving their value from immovable property and rules on dividend distributions, while some very specific rules can also be found in the Portuguese tax treaty network dealing with exit taxes on individuals, dividend distributions and the exchange of information regarding tax avoidance.

Finally, at an EC law level, the compatibility or otherwise of Portuguese anti-abuse rules has been discussed in the academic literature (e.g. thin capitalization, exit tax and CFC rules), but the few cases where the application of those rules was implemented within an EU scenario by the tax authorities is probably the justification for the limited number of court cases dealing with the issue that have been reported. Notwithstanding, where thin capitalization rules were applied to an EU lender, Portuguese case law was consistent in affirming its incompatibility with the fundamental freedoms after the *Lankhorst-Hohorst* case, which also led the Portuguese legislator to amend the domestic rule to ensure its compatibility with ECJ case law. Currently there is a pending infringement procedure against the Portuguese exit tax, which the EC Commission has announced it will refer to the ECJ. Moreover, the compatibility of specific anti-abuse rules introduced with the

Parent–Subsidiary and the Interest and Royalties Directives have been questioned and it is unclear whether such rules would be upheld by the ECJ.

1. Domestic anti-avoidance provisions with an international scope

1.1. General overview

Tax issues related to evasion, abuse and avoidance at both a cross-border and purely domestic level have recently been the focus of renewed attention from the Portuguese legislator, tax authorities and taxpayers. Currently Portugal follows the major international trends in the adoption of anti-abuse rules, namely those which have an international focus or effect. One striking example of this was the introduction in 2008 of a regime of disclosure of tax planning by entities that render tax services.

The Portuguese GAAR , introduced in 1999, was preceded in the mid-1990s by the introduction of specific anti-avoidance rules (SAAR) with an international focus, such as thin capitalization rules (1995), CFC rules (1995) and a series of rules dealing with low-tax jurisdictions, namely blacklisted jurisdictions. After 1999 Portugal introduced, among other things, rules on exit tax (2006) and dividend stripping (2006), as well as a specific rule on abuse of its participation exemption regime (2005). Although a series of anti-abuse provisions are currently available to the Portuguese tax authorities they have so far focused primarily on applying rules that deal with deductible expenses that are intended to reduce Portuguese corporations' taxable base, namely those that create deductible expenses such as those arising from payment of services or by creating interest deductions or capital losses such as those arising from a sale of shareholdings and the liquidation of companies where residents in blacklisted jurisdictions[1] are involved. Therefore, there are a very limited number of court cases dealing with anti-abuse rules and most of the reported ones deal with the application of specific rules where blacklisted jurisdictions are concerned.

1.2. General anti-avoidance provisions with international focus or effect

The Portuguese GAAR entered into effect in 1999 and from the outset it has been considered that it would apply to both domestic and cross-border transactions alike. Therefore there has been no attempt to introduce any additional avoidance provision that would specifically target cross-border transactions.

The current version of the GAAR reads as follows:

> "juridical acts or agreements do not produce effects for tax purposes, when it is evidenced that they were performed by artificial or fraudulent means and abuse of legal forms, with the sole or principal objective of reducing, eliminating or

[1] Cf. Decree no. 1501/2004, dated 30 December (as amended).

deferring the taxes that would have been payable if juridical acts or agreements of equivalent economic result had been pursued, or with the purposes of obtaining tax advantages that would not be achieved, totally or partially, with the use of those means; in such cases, the taxes will apply as if those means and forms were not used and no advantage would also apply."[2]

Case law dealing specifically with the issue of anti-abuse in a tax treaty scenario and of any court-developed anti-avoidance provision does not, to the best of the reporters' knowledge, exist. Notwithstanding, the Portuguese courts have used general law interpretation principles (e.g. interpreting tax law in accordance with its object and purpose so long as the purpose is not inconsistent with the text of the law) to qualify and/or recharacterize items of income,[3] namely prior to the introduction of the GAAR. The Portuguese General Tax Law actually states that, when in doubt regarding the interpretation of the sense of tax rules dealing with the taxable base, one should look at the "economic substance of the taxable events".[4] In addition the GAAR also stresses that one should look for the judicial acts or agreements of equivalent economic results.

1.3. Specific anti-avoidance provisions with international focus or effect

Portugal's domestic tax law currently features the majority of specific anti-abuse rules common to other jurisdictions, such as a thin capitalization provision, a CFC provision, an exit tax on the emigration of both individuals and corporations, tax disclosure obligations of aggressive tax planning, transfer pricing regulations closely following the OECD guidelines, rules on tax-driven mergers and reorganizations, specific rules denying full participation exemption relief where dividends were not subject to effective taxation, bond washing and dividend stripping rules and a series of rules dealing with the non-deductibility of costs and with use of and transactions involving residents in low-tax jurisdictions. Portugal has also recently followed the members of the Joint International Tax Shelter Information Centre (JITSIC) in adopting disclosure obligations for taxpayers on tax planning. The main SAARs with international focus or effect are briefly described below.

Portugal introduced its thin capitalization rule in 1995. Under current rules if a non-resident entity, other than a resident of an EU Member State, is deemed to be an associated enterprise of a Portuguese resident entity according to the Portuguese Corporate Income Tax Code, interest payments may not be deducted from taxable income if they exceed, in a taxable period, twice the share capital participation held by such a non-resident entity. The thin capitalization rule has been applied by the tax authorities on a number of occasions and has informed some court decisions,

2 Cf. art. 38, no. 2 of the General Tax Law.

3 Cf. Supreme Administrative Court, Case *BNU*, dated 25 November 1998, which dealt with the issue of "bond washing" transactions aimed at recharacterizing interest income into capital gains. The Court ruled that capital gains realized at the time of the sale of bonds were in effect interest by applying retroactively a later amendment to the relevant tax law to curb such transactions based purely on interpretation of the law principles.

4 Cf. art. 11, no. 3 of the General Tax Law.

but most of the reported cases have dealt with its use where an EU lender was concerned and after the ECJ *Lankhorst-Hohorst* decision the rule was amended and such court cases merely applied the ECJ's case law on the issue.

As for its CFC rules, their introduction also occurred in 1995. According to these rules a foreign entity is deemed a CFC if resident in a low-tax jurisdiction. Low-tax jurisdictions are blacklisted jurisdictions and also those where no tax is paid or where the effective foreign tax rate is equal to or less than 60 per cent of the Portuguese IRC rate (i.e. currently 15 per cent or less based on the current IRC rate of 25 per cent) and controlled by Portuguese residents (individuals or corporations) if these latter own, directly or indirectly, at least 25 per cent of the capital or 10 per cent thereof, where more than 50 per cent of the capital is held by residents in Portugal. The Portuguese tax authorities have already resorted to the application of the CFC rule where the CFC was resident in a blacklisted low-tax jurisdiction, but there are currently no reported court cases of the rule's application having being extended to other jurisdictions on the basis of the material criteria established for determining a low-tax jurisdiction.

In 2006, the Portuguese legislator introduced specific exit tax provisions. The provisions state that in case of the transfer of seat and place of effective management of a Portuguese company to another Member State or if a permanent establishment ceases its activities in Portugal or transfers its Portuguese located assets to another Member State (a) the taxable base of that financial year will include any unrealized capital gains in respect of the company's assets, whereas unrealized capital gains from purely domestic transactions are not included in the taxable base; and (b) the shareholders of the company that transfer its seat and place of effective management abroad are 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. As for individuals, the current exit tax rules establish that they are deemed resident for the year of transfer of residence and for a subsequent four-year period if they are Portuguese nationals who transfer their residence to a blacklisted jurisdiction, unless proof is presented that the transfer is based on a valid reason, such as on secondment by an employer for performing a temporary activity. The application of the provision has not been reported in any court case, perhaps due to the fact that it is very unusual for a Portuguese individual to emigrate to such jurisdictions. It is also possible that some technical issues concerning the provision's application may have so far prevented its application by the tax authorities.

In 2002, the Portuguese Parliament granted a legislative authorization to the government to enact legislation to fight tax evasion resulting from tax arbitrage techniques commonly referred to as bond washing and dividend stripping, specifically through cross-border transactions.[5] Although the legislative authorization was not used in the relevant year, in 2006 a new provision entered into force, which was aimed precisely at deterring dividend stripping transactions by establishing that dividends paid to companies that benefit from a full or partial corporate income tax exemption would be subject to an autonomous taxation (*tributação autónoma*) by way of a withholding tax at a rate of 20 per cent if the shareholding had not been

[5] Cf. Francisco de Sousa da Câmara and José Almeida Fernandes, "Portugal To Enact Anti-Tax Evasion Measures", *Tax Notes International*, vol. 27, no. 5, 2002-07.

held for at least one year at the time the dividends were received and the minimum holding period was not satisfied after the distribution. The rule was intended to counter the sale of shares with a dividend, before the dividend distribution, and the repurchase ex-dividend of those same shares after the distribution of the dividend, namely through the use of repo or share loan agreements. Notwithstanding, the use of equity swaps or total return swaps that may give rise to so-called "manufactured dividends" has not been subject to any legislative or administrative regulation, but one should mention that where derivatives and financial instruments are concerned a broad SAAR is applicable that is aimed precisely at counteracting possible abuse resulting from a possible recharacterization of income where these types of instruments are used by taxpayers.[6]

In 2008, Portugal also introduced a tax disclosure regime for tax planning, whereby entities that render services on tax and compliance issues are mandatorily obliged to report to the Portuguese tax authorities any proposed tax planning exclusively or predominantly aimed at achieving a tax advantage. The rule may be perceived as also having an international effect, since among the listed transactions that should mandatorily be disclosed are those involving low-tax jurisdictions and financial transactions involving the use of hybrids, which are commonly structured in a cross-border setting.

The main focus of the Portuguese tax authorities has so far centred on applying rules that deal with deductible expenses that intend to reduce the taxable base of Portuguese corporations, namely those that create deductible expenses such as those arising from payments for services or by creating interest deductions or capital losses such as those arising from a sale of shareholdings and the liquidation of companies either by resorting to general or specific anti-abuse provisions dealing with low-tax jurisdictions. In fact, as for counteracting abuse on cross-border transactions, the main target of the Portuguese legislator has been the use of blacklisted jurisdictions, where the existing anti-avoidance rules have been consistently applied and enforced by the Portuguese tax authorities.

We anticipate that the major controversies that are likely to occur in the future will deal specifically with the application of the GAAR and SAAR involving residents of countries with which Portugal has concluded tax treaties.

1.4. The relationship between DAAR and double tax treaties

1.4.1. Treaties take precedence over domestic law

According to the Portuguese constitutional system, international rules binding the Portuguese state should prevail over domestic provisions, regardless of whether the latter rules were enacted before or after the former.

In particular, the rules and principles of general or ordinary international law are an integral part of Portuguese law. In addition, rules established in international conventions duly ratified and approved by the Portuguese competent bodies shall,

6 Cf. art. 78, no. 11 of the Corporate Income Tax Code, introduced in 1997, which specifically allows for a recharacterization to be made in order to take account of the actual substance of transactions "if the substance of a transaction or a set of transactions differs in its form, timing, source and character of the payments, receipts, profits and costs, gains and losses, arising from such transactions".

following their official publication, apply in Portugal as long as they remain internationally binding with respect to the Portuguese state. This means that DAAR must not be applied if this would imply tax treaty provisions being overridden.

Therefore, it is essential to determine in which areas there is potential for conflict between these types of provisions.

In cases of conflict, the authors consider that the Portuguese (or foreign) tax authorities cannot apply domestic rules that would override a specific tax treaty signed by Portugal.

1.4.2. How DAARs interact with or complement double tax treaties

The Portuguese legal system did not adopt specific DAARs to prevent double tax treaty abuses, like the 1962 Swiss Decree or the German tax provisions (e.g. section 50(d)(1a) of the German Tax Code).

Notwithstanding, as mentioned above, there are currently several SAARs and a GAAR that may also apply in situations involving the application of double tax treaties. As mentioned, we may distinguish three types of rules: (a) some targeted to prevent tax erosion in a domestic or international environment (e.g. rules that prevent expenses, costs and losses being tax deductible; transfer pricing provisions, limitations to the transfer of losses, etc.); (b) other rules specifically designed to combat tax avoidance at an international level (e.g. (i) rules preventing the tax deductibility of payments to entities located in low-tax jurisdictions; (ii) thin capitalization rules that only apply to loans made by non-resident entities; (iii) CFC rules; (iv) exit tax rules; and, finally (c) the last set of rules (the GAAR and its procedural provisions) that allow the tax authorities to recharacterize operations in a purely fictional way. The decision to be taken by the tax authorities determines, in the first place, that the acts or agreements performed by taxpayers do not produce effects for tax purposes; and, secondly, will establish the tax due with reference to an agreement or transaction with an equivalent economic result, as if no artificial or fraudulent act had been perpetrated and the legal forms that should have been used by taxpayers (without abuse) were used, i.e. the rules that should apply without granting a special tax advantage for the taxpayer. In doing so, the tax authorities determine the relevant "facts" for tax purposes; those that should be "ignored" and those to be "considered" instead, in order to calculate and determine the final "tax invoice".

Before the strict legal controversy takes place, the parties (taxpayers and tax authorities) invariably face a few rounds in the fight for facts. Their manipulation may change domestic taxation as well as the consequent international tax treatment, so we do not see how is it possible to agree with the complacent opinion expressed by the Committee on Fiscal Affairs that no conflict may occur between the GAAR (or its application) and a specific treaty provision.

Experience and case analysis shows that in the area of GAAR application one can confront, often arbitrarily, a tremendous discretionary reconstruction or substitution of facts and a substantial amendment of reality. As the Portuguese rule shows, the tax authorities are empowered to look for an act or agreement of equivalent economic result, under different legal forms and in doing so they can omit transmissions, disregard the existence of specific entities, and change the options adopted by taxpayers (e.g. a dissolution and liquidation is considered irrelevant, the proceeds from a sale and purchase agreement become dividends, etc.). The use of such an open-ended GAAR becomes controversial and subject to a preliminary scrutiny from a constitutional point of view.[7] However, the reporters expect that the national courts will not allow such reconstructions in the presence of double tax treaties (signed before or after 2003 and the publication of the OECD MC) since they believe that the tax authorities do not have the absolute power to recharacterize facts in a manner that allows shifts in taxation between the two contracting states.[8]

While few cases are pending in court, the fact is that to date not a single case has been concluded (to the best of the reporters' knowledge) in which the tax authorities have used the GAAR with success. However, from the few cases that were initiated by the tax authorities one may already question their results, both in terms of domestic law and tax treaties. Let us just consider two examples where the GAAR application by the tax authorities was considered, as follows:

(a) In one situation a Portuguese company contributed capital to a subsidiary[9] located in the Madeira International Business Centre (which was incorporated with the purpose of enhancing the international capabilities of the group), which benefited from some tax exemptions. The subsidiary lent part of those amounts to a non-resident company which paid interest in return. In Portugal no taxes or very few taxes were paid considering that, first, the recipient of interest benefited from a tax exemption and, secondly, with the proceeds of such interest (then characterized as profits), it paid dividends to the parent company, which benefited, at the time, from the domestic participation exemption method.[10] Stating that the taxpayer deliberately created this tax avoidance situation, the tax inspectors ignored the interposition of the exempt company (e.g. the Madeira company) and considered that taxation should occur as if the interest had been paid directly to the Portuguese parent company. If the company that received the interest and paid the dividends was a non-resident company no doubt this decision might have changed the power to tax between the contracting states and the obligations imposed on the state of residence (in this case, Portugal). Would such a company be considered a

7 The rule and its application may collide with constitutional principles, such as the principles of legality (and the prohibition of analogy) and equality (taxpayers are not treated in the same manner) as well as the principle of certainty and confidence, which collapse under a system where taxpayer expectations disappear. Cf. Alberto Xavier, *Direito Tributário Internacional*, 2nd edn, Coimbra, 2007, p. 480.

8 The tax authorities are not bound by the qualification of an agreement made by the parties (cf. art. 36 no. 4 of the General Tax Law). Moreover, if they invoke and prove simulation taxes should be levied in accordance with the real agreement intended by the parties (cf. art. 39 of the General Tax Law). However, these rules do not represent the acceptance of any principle of substance over form or business purposes or the like. What is being considered and can be challenged under these provisions is the statements and the qualifications made by taxpayers. For these purposes, the tax authorities may find other materials and documents but the "facts" are – and should be considered – those presented by the rules of evidence, i.e. the reality that effectively occurred.

9 In the past the Portuguese government had officially recommended the use by Portuguese groups of Madeira companies to enhance its economic internationalization and hence it was unexpected for Portuguese groups to face such a challenge for so doing by a resort to the GAAR.

10 The tax authorities only later introduced an SAAR to deny full participation exemption where the dividends distributed were not subject to effective taxation.

mere conduit vehicle? This is one of the discussions still underway in court. Moreover, in the case *sub judice* tax treaty obligations might even have been jeopardized if the tax authorities prevented the parent company from benefiting from the credit method that would have applied had the interest been paid directly from the source to the company located in mainland Portugal.

(b) In another situation, a company entered into a share buy-back agreement with some directors/shareholders. Capital gains obtained by the individuals, with the sale of shares, were tax exempt. The tax inspector determined that the operation was highly motivated for tax reasons and considered that the transaction should be characterized instead as a distribution of dividends subject to tax on the hands of the directors; if the directors were non-residents this would have had an impact on the treaty article that might have applied.

Grosso modo, considering the three types of DAARs we may say that, as a rule, some do not seem to conflict with treaties (i.e. the taxable income provisions that deny the tax deductibility of some expenses, costs, losses, etc.– the so-called first set of rules).[11] Some others may or may not conflict with tax treaties (e.g. CFC, thin capitalization and exit rules, just to give some examples), while the application of the GAAR, which may allow the tax inspectors of one contracting state to ignore the facts that occurred and construe a reality that may alter the taxing powers of the contracting states, have an enormous potential for conflict with the treaty agreements.[12]

In spite of the OECD MC commentary on article 1, the reporters believe that DAARs may be used to determine the tax liability of a specific taxpayer, but not to change the fact pattern in a way that first would jeopardize the agreement signed between two contracting states and, secondly, would undermine the confidence and certainty of taxpayers' legitimate expectations that are protected by the Portuguese Constitution.

The reporters acknowledge that the stance adopted by the commentary of the OECD MC since 2003 is quite straightforward, but also recognize that (a) several states made observations (including Portugal); (b) the majority of the Portuguese treaty network was still signed by Portugal before 2003; (c) apart from SAARs in the treaties or in their protocols, the Portuguese authorities never felt that it was appropriate to indicate that a treaty would not prevent the application by a contracting state of its own DAAR (apart from the convention signed with Moldova on 11 February 2009 which has not yet entered into force).

11 In any case, such conflicts may occur if the non-discriminatory principle is not observed.

12 The reporters do not consider that these issues should be dealt with as a mere problem of qualification leading or not to double taxation as defended by Alberto Xavier (*op. cit.*, pp. 480–483); this would extend in an unacceptable way the power of the state that was applying its GAAR, not only because it would be invested with the power of "fixing the facts", regardless of what they could have been, but also considering the new recommendations to resolve conflicts of qualifications, as introduced in para. 32 *et seq.* of the commentary on arts. 23A and 23B of the OECD MC. In this matter pertinent and accurate statements may be found in Frederik Zimmer, "Domestic Anti-Avoidance Rules and Tax Treaties – Comment on Brian Arnold's Article", 59 *Bulletin for International Fiscal Documentation*, 1 (2005), pp. 25–26; Brian J. Arnold and Stef van Weeghel, "The relationship between tax treaties and domestic anti-abuse measures", in *Tax Treaties and Domestic Law*, EC and International Law Services, vol. 2, IBFD Publications, 2006, pp. 91–92; Luc De Broe, *International Tax Planning and Prevention of Abuse*, vol. 14, Doctoral Series, IBFD, pp. 390–391.

In addition, the Portuguese state (in a potential conflict with other contracting states) or taxpayers may also invoke that in order to apply the DAAR, in the treaty context, the tax authorities would also have to evidence that (a) the main purpose of the transaction was to obtain a treaty benefit in a manner considered contrary to the purpose of the treaty itself; (b) the treaty itself would not restrict it (expressly or tacitly having narrower anti-avoidance provisions); (c) the other contracting state agreed with such abuse being challenged by the use of that DAAR. Considering the relevance recently granted to the mechanisms of exchange of information and for the prevention of tax avoidance it seems unacceptable that the contracting state may undertake unilateral actions to jeopardize the ultimate goals to be achieved by the treaty.

Moreover, one should bear in mind that the observation on the commentary concerning the application of DAAR made by Portugal (paragraph 27(8) of the commentary on article 1), stipulates that Portugal will not adhere to the commentary on article 1, on the relationship between domestic anti-abuse rules and tax treaties, "if the prevailing hierarchy of tax conventions regarding internal law is not respected". Although one may have difficulty in fully understanding the extent and parameters of this position, it seems clear that this paragraph is intended to make the point that treaties prevail over domestic rules; if a conflict exists the DAAR cannot be applicable. Unlike other states, the Portuguese authorities preferred to stress the general principle, instead of giving examples of a specific DAAR that may or may not conflict with the treaty. In addition, with this observation, the Portuguese authorities also avoided defining who should be considered bound by this observation, i.e. Portugal or any other contracting state that enters into an agreement with Portugal and may try to apply its own DAAR in the context of a treaty signed with Portugal.

This observation should also be considered to prevent other contracting states from denying the application of treaties to companies incorporated and developing their activity in Madeira/Portugal, based on the argument that they benefit from specific exemptions and that their "tax residence" could be challenged.[13] The same principles can also be invoked to prevent other contracting states from applying their own CFC rules against Madeira companies that could have benefited from specific corporate tax incentives (e.g. exemptions or reduced rates), although the application of the GAAR by the Portuguese tax authorities in operations involving Madeira companies may somewhat dilute the strength of the arguments used by the Portuguese state.

13 Curiously, one of the Portuguese treaty negotiators expressly defended, in the course of an analysis of the application of tax treaties to entities developing this activity under the Madeira Free Zone regime, that other states could not prevent these entities from benefiting from the Portuguese treaty network, unless this was expressly referred to under a specific anti-avoidance provision inserted in the treaty, as was the case with the US tax treaty. This would result from the prevailing of tax treaties over domestic rules and, therefore, it is not possible to invoke a mere interpretative approach (e.g. substance over form or economic substance) to justify any recharacterization that would result in a different outcome that violated the treaty itself and the principle of legality. This position reiterated the position adopted by the negotiators of the Portuguese treaties and was justified by the observation made to Portugal. See Maria Margarida Cordeiro Mesquita, "Aplicação de Convenções sobre dupla tributação e empresas instaladas na Zona Franca de Madeira e de Santa Maria", in *Direito e Justiça*, *Revista de Faculdade de Direito de Universidade Católica Portuguesa*, vol. XI, 1997 tomo 2, pp. 119–129 (pp. 128–129).

In addition, it seems that both national and foreign tax inspectors should be prevented from making use of their DAAR, if such actions might change the taxation that would occur under the application of the double tax treaty. Otherwise the principle *pacta sunt servanda* could indeed be challenged.

1.5. Abuse of the tax treaty itself: domestic law principles or interpretation of the treaty?

In spite of the straightforward position adopted by the OECD MC in considering that states envisaged the existence of abuse of a treaty either under domestic law principles or through the interpretation and possible application of the treaty itself, determining under which of these categories Portugal falls remains complex.

There is no doubt that from a Portuguese legal point of view:

(a) taxes are imposed by the competent national bodies – Parliament and government – as domestic law;

(b) treaties are part of the Portuguese legal system upon their approval, ratification and publication in the Official Gazette and according to the monistic system adopted by the Constitution they prevail over domestic rules in cases of conflict;

(c) the double tax treaties signed by Portugal (currently 54) may, therefore, restrict the application of domestic law;

(d) the concept of abuse and, in particular, of treaty abuse is not defined and it is not probably perceived in the same manner considering the different treaties signed by Portugal (e.g. sometimes there is not even a uniform understanding of such abuse within a sole state either considering different abstract entities (tax authorities, taxpayers, courts) or even within the same specific entities (e.g. different departments of the tax authorities or different court levels) during the analysis of one case or considering distinct cases with the same fact pattern);

(e) when a state invokes the existence of abuse and applies its own DAAR it usually intends to increase its right to tax (both through the recharacterization of income (e.g. exempt capital gains are requalified as dividends and taxed as such in a sale of shares of a cash company or in the quoted example of a share buy-back – usually by the source state) or by denying the possibility for a taxpayer to benefit from a specific advantage granted by the treaty (e.g. the application of the exemption method is denied on dividends received, including with the requalification that such income should be treated for tax purposes as interest)), but such a decision might be contested and challenged either by the other contracting state and/or the taxpayer that may become subject to double taxation. Here below we will comment on this possibility, suggesting that such occurrences should be limited.

For the time being, the Portuguese courts have not yet been called upon to untangle disputes where the application of the GAAR is said to be in conflict with a specific treaty. The Portuguese tax authorities have been using the GAAR to challenge domestic and international operations not covered by treaties (e.g. blacklisted jurisdictions). Other DAARs have been used in a treaty context (those we defined as the first set of DAARs) but their scope does not seem to conflict with a treaty being solely aimed at eroding corporate or individual tax obligations. On the whole, the

Portuguese state has not been invoking the abuse of treaties to justify tax adjustments and additional tax assessments to taxpayers.

To date the greatest disputes involving treaties have centred upon qualifying income under the faculty granted to the tax authorities to qualify an agreement and the income paid in return (e.g. services, technical assistance and royalties *vis-à-vis* fees not taxed at source or royalties subject to withholding tax in accordance with the Portuguese reservation and policy followed in its tax treaties), and whether non-resident taxpayers may benefit from the treaties if they do not provide specific certificates, issued in Portugal and required by Portuguese domestic law, to the payors of income, duly certified by their own tax authorities attesting to several data, including residence and characteristics such as "beneficial ownership".

However, the classical examples (some of them illustrated above) show that Portuguese treaties may be abused both by taxpayers and by the states themselves. The OECD commentary addresses the first type of abuse committed by taxpayers and concludes that states may apply their own DAARs once taxes are imposed by domestic law. They may, therefore, protect their tax base, their resources and their interests. This is acceptable and comprehensible from a general and hypothetical point of view. However, in the presence of a tax treaty, there are limits for the states to respect, limits for the legislative bodies, as well as for administrative bodies and even the judiciary.

In the absence of a specific definition of abuse, one may follow the guideline referred to in paragraph 9(5) OECD MC commentary on article 1. It seems clear that an abuse requires that a taxpayer obtains a tax advantage through the use of a treaty that is contrary to the object and purpose of the relevant treaty provisions.

In this case the burden of proof rests on the tax authorities. The mere allegation that a taxpayer obtained a tax advantage, found and used a loophole, or entered into a transaction that led to double non-taxation does not suffice to pass the test that justifies the application of a DAAR, in particular the GAAR. It is important to determine how the specific provision, considering its wording and spirit, and the treaty as a whole, have been abused and what were the expectations of both contracting states in that situation.

It is not acceptable for the tax authorities of a state to proceed with a recharacterization of income under the pretext that they are fighting tax evasion and/or tax avoidance, when in fact they are shifting the taxing powers under the distributive rules (or, at least, justifying their intrusion in an area that was closed). This decision and behaviour is contrary to good faith. It would also be unacceptable for a state to introduce changes to its domestic rules (e.g. DAAR) just to curb and circumvent its own limitation to tax under a specific treaty that was signed previously.

No doubt preventing tax avoidance has become one of the purposes of tax treaties – after the amendment of paragraph 7 OECD MC commentary on article 1 in 2003 – but the principal purpose of treaties is still to promote the exchange of goods and services by eliminating double taxation. It is crucial to stress the limits for states to use their own domestic weapons – not only to protect taxpayers from any type of discretionary power but also to protect the other states and international order as a whole. Furthermore, it seems that enhancing the exchange of information and the mutual procedure agreement (including with mandatory arbitration) should serve the purposes of combating tax avoidance by taxpayers but applying the relevant tax treaty on a consensual basis, which means that a state should be prevented from changing the allocation of taxing income or denying or changing unilaterally the method to eliminate double taxation (just to refer to the two sets of rules that might be used by the state of source or residence for its own benefit) invoking a DAAR, if such interpretation and application is not shared by the other contracting state that should then act accordingly. In addition, the text of the treaty itself and its spirit cannot be ignored, which of course prevents the states from applying their DAAR in a manner that is absolutely contradicted by the wording of a specific provision and the text of the treaty as a whole.

Taking into account all these considerations, it seems important to determine the route that should be followed in Portugal for the state (the tax authorities) to apply DAARs, whether as a state of source or of residence, and at the same time to predict how it is possible that the state should react if other states use their own DAARs against Portuguese resident taxpayers.

The burden of proof to apply any DAAR clearly rests with the tax authorities. The task imposed may be quite difficult and complex when the law uses terms that are subjective by nature. Paradoxically, when the authorities have considerable discretionary powers, the legal requirements should really be seen as limits that might be analysed under specific procedural rules and judicially scrutinized. The GAAR is the finest example of this type of rule. The Portuguese tax authorities have a considerable task.

They have to start with the facts and domestic legal and procedural rules. They must: (a) describe how the transaction occurred and its true economic substance; (b) determine the facts evidencing that such a transaction was made with the sole or principal goal to avoid the tax that would have been due in case the taxpayer had entered into an operation with an equivalent economic result; (c) describe the transaction and operations with an equivalent economic result and indicate the tax provisions that then would be applicable. Besides respecting these requirements, the constitutional limits should not be ignored (principles of legality – prohibition of analogy – certainty, ability to pay, good faith, etc.).

Subsequently, the tax authorities should verify whether there are international constraints that may prevent them from acting as such, namely EC law (either primary or secondary law) or double tax treaties. Will the application of the GAAR conflict with a specific treaty (or treaties) that might be applicable? The tax authorities should carefully verify and interpret the specific treaty provision (to compare it with the facts and the operation that occurred as well as with the “facts” proposed by the authorities and their result), the treaty as a whole, and the expectations of the parties. Was this transaction protected by the treaty (suppose that this analysis is being made at the state of source and the power to tax the income is exclusively attributed to the state of residence, whether the latter exercises such power or not by adopting the exemption method or attributing any type of tax incentive to the recipient of income)? Does the approach and interpretation of facts made by the tax authorities respect the wording of the treaty? Was the eventual and potential advantage obtained by the taxpayer the main purpose for entering into that transaction and is the obtaining of such treatment contrary to the object and purpose of such treaty? Does the treaty contain any GAARs or SAARs? And other treaties? Does it make any difference whether the treaty was signed before or after

2003? Do any treaties signed by Portugal combat such a type of arrangement with an anti-avoidance rule? Is the other contracting state in agreement with the application of such GAAR and, in particular, with the results that are imposed on its own side in order to ensure the elimination of double taxation? Was the global tax burden substantially reduced by the taxpayer? If the GAAR applies is it still possible to defend that the treaty rule is respected, considering that treaties prevail over domestic law and that Portugal has entered a specific observation in this respect?

If Portugal is the state of residence the application of the imputation or exemption method is of paramount importance in order to ensure respect for the treaty and the elimination of double taxation. As observed, the residence state cannot simply deny the application of the exemption method with the sole justification that a domestic or treaty exemption applies and the source state did not tax the item of income. The tax authorities will be bound to respect the same principles mentioned above, if the treaty rules, object and purpose, require them to be followed, so as to avoid the reckless and ill-founded overriding of its terms.

2. General and specific anti-avoidance provisions in tax treaties

2.1. General overview

The Portuguese tax treaty network was substantially negotiated between 1994 and 2003 when 37 treaties were concluded. The treaties closely followed the 1977 OECD MC. Portugal did not conclude that there was a necessity to adopt a position deviant from the OECD MC in relation to the inclusion of treaty-based general or specific anti-abuse provisions, although the Portuguese tax authorities had already experienced some difficulties in the application and proper enforcement of these same treaty rules, in particular the application of beneficial ownership.

Moreover, the cautious approach of the Portuguese negotiators in allowing the non-entitlement of treaty benefits to residents on the basis of DAARs, coupled with the fact that a Portuguese GAAR was only introduced in 1999 after a lengthy discussion of its features and legality, may have played a significant role in the reluctance encountered in dealing with the issue at a treaty level.

Furthermore, the tax treaty policy of inclusion of the preferential tax regimes of the International Business Centres of Madeira and Azores in the scope of application of the treaties may also have played a role in initially avoiding measures that might undermine or compromise their application (e.g. limitation on benefits or provisions requiring effective taxation).

Therefore, it is not surprising that Portuguese tax treaties have very limited provisions dealing with anti-abuse rules, whether domestic or treaty based, and only in the most recent treaties have we seen the introduction of general treaty anti-avoidance provisions and the issue of treaties and domestic anti-abuse rules specifically addressed. However, from 2000 onwards the Portuguese tax treaty negotiators were already aware that in future tax treaties it would involve the "inevitable ...

acceptance of the inclusion in some conventions of anti-abuse clauses … that exclude, at least, some entities or activities”.[14]

2.2. Specific treaty provisions allowing application of domestic anti-avoidance provisions

Although Portugal has made an observation to the OECD MC commentary on article 1 clearly indicating that domestic anti-abuse rules could not lead to disrespect of the prevailing hierarchy of tax conventions regarding domestic law, it has seldom dealt with the issue in its tax treaties either on a general or specific basis after the reservation was introduced in 2003.

The first treaty where the issue is expressly dealt with in a comprehensive manner is the treaty with Moldova, concluded in 2009 and not yet in force, where Portugal has expressly agreed “that the provisions of the Convention shall not be interpreted so as to prevent the application by a Contracting State of the anti-avoidance provisions provided for in its domestic law”.[15] The far-reaching latitude granted to both states to deny the entitlement to treaty benefits on the basis of their own domestic law is unexpected and may raise constitutional and legal conflicts with the hierarchy of tax treaties, as well as contradicting the position first taken during the consultation that led to the OECD MC 2003 update, as expressed in the observation then introduced.

On a specific basis, where thin capitalization is concerned, Portugal has adopted a quite consistent approach, introducing into the protocol of its tax treaties a clarification that the non-discrimination article[16] based on article 24 of the OECD MC does not hinder the application of domestic thin capitalization rules. The fact that thin capitalization rules were among the first and oldest anti-abuse provisions with an international effect introduced by the Portuguese legislator into the Portuguese Corporate Income Tax Code, to tackle abuse in a cross-border scenario, in 1996, might have played a key role in identifying potential problems that could arise at the tax treaty level and hence the specific caveat introduced in protocols regarding their compatibility with treaty law.[17] Without an express caveat in the tax treaty, the applicability of the domestic rule needs to be scrutinized in detail, namely against the background of the relevant tax treaty provisions and on a case-by-case basis.

14 Cf. Maria Margarida Cordeiro Mesquita, “A Política Convencional Portuguesa em Matéria de Dupla Tributação: Contributos para uma Redefinição”, in *Estudos em Homenagem ao Professor Doutor Soares Martinez*, vol. II, Almedina, 2000, p. 381.

15 Cf. Protocol, no. 2, item (a) of the tax treaty concluded with Moldova.

16 The treaty concluded with the Netherlands also specifically mentions that domestic thin capitalization rules should not be deemed contrary to art. 9, but provided some further conditions are met: “associated enterprises can show that due to the special characteristics of their activities or their specific economic circumstances, the conditions made or imposed between those enterprises are in conformity with the arm’s length principle” (cf. protocol, §X of the treaty concluded with the Netherlands). Similarly, the treaty concluded with Chile also addresses the issue in the same terms.

17 Cf. treaties concluded with Cape Verde, Chile, China, Greece, India, Ireland, Macao, Malta, Mexico, the Netherlands, Romania, Russia, Singapore, Spain and Venezuela.

Moreover, Portugal has introduced into the treaties with the Netherlands,[18] Norway[19] and Sweden[20] specific provisions in the relevant capital gains article, which seem aimed at allowing the application of exit taxes on the gains realized from the alienation of shares or other corporate rights (also *jouissance* rights or debt-claims in the case of the Netherlands) by individuals who were "a resident of that other State immediately preceding the time when he became a resident of the first-mentioned State" and that he "was the owner of the above-mentioned shares, rights or securities while he was a resident of that other State". The requirements under which a state is not restricted in taxing such gains are variable as for the relevant time period (five years for Norway and Sweden, whereas with the Netherlands a ten-year period is required). Furthermore, the provision included in the treaty with Norway also requires that the individual is a national of the other state and that "such gains are not subject to tax in the first-mentioned State".

Finally, the fact that the Portuguese tax authorities have had recourse to a general business purpose test required for tax deductible costs, as a means to counteract abusive transactions aimed at reducing corporations' taxable income, has also impelled the Portuguese negotiators to introduce recently in protocols[21] a reference stating that the treaty should not be construed to raise any compatibility issue with domestic rules on the burden of proof where the deductibility of expenses is concerned. However, the moot point is determining whether discrimination actually occurs where the deductibility of costs is denied to non-residents protected by the relevant tax treaty.

2.3. General anti-avoidance provisions in tax treaties

Portugal has recently adopted a policy of introducing some general provisions into its treaties, aimed at counteracting an application of the treaty provisions that might be said to be an abuse of the general principles of the treaty. The said provisions have been grouped under the title of "Limitation on benefits" and have been consistently adopted in treaties with the Baltic countries (Estonia, Latvia and Lithuania), where the relevant provision reads

> "the provisions of this Convention shall not be construed as obliging a Contracting State to grant the benefits under this Convention to any person that is a resident of the other Contracting State, if, according to the competent authorities of both Contracting States, the receipt of those benefits will constitute an abuse of the general principles of the Convention."[22]

Apparently, it seems that both contracting states were concerned as to possible "abuses as being abuses of the convention itself, as opposed to abuses of domestic

18 Cf. art. 13(5) of the treaty concluded with the Netherlands.
19 Cf. art. 13(4) of the treaty concluded with Norway.
20 Cf. art. 13(4) of the treaty concluded with Sweden.
21 Cf. protocol of treaties concluded with Canada, China, India, Singapore, Macao, Greece, Russia, Pakistan, Malta and South Africa.
22 Cf. art. 27 of the treaty concluded with Estonia, art. 28 of the treaty concluded with Latvia and art. 28 of the treaty concluded with Lithuania.

law".[23] The respective protocols further added that the provision might also be used to tackle situations where a sharing of taxing rights might be questioned, namely by a densification of the concept of "abuse of the general principles of the Convention" to cover also

> "a situation where the benefits under the Convention shall be granted by a Contracting State in respect of an item of income arising in that State which is not subject to taxation in the other Contracting State or is subject to taxation at a considerably lower tax rate than the tax rate generally applicable in that other State",

which seems to allow the states to agree that a lack of effective taxation at the residence state might render the benefit of the treaty provisions unavailable.

In 2009, Portugal expressly established in the protocol to the treaty concluded with Moldova that treaty benefits would not be granted where "the main purpose or one of the main purposes of any person concerned with the creation or assignment of the property or right in respect of which the income is paid to take advantage of those provisions by means of such creation or assignment". Contrary to the agreement that was reached with the Baltic states, where it was implied that the denial of treaty benefits on the basis of abuse required an agreement from the other state and on the basis of a previous mutual agreement procedure, the treaty with Moldova does not seem to require any consultation with or agreement from the other state to deny treaty benefits to a resident of either of the contracting states. The underlying view seems to be that "any abuse of the provisions of a tax convention could also be characterized as an abuse of the domestic provisions of domestic law",[24] which should be noted as somewhat contradictory to the view set out in the treaties with the Baltic states and the Portuguese observation to the OECD MC commentary on article 1 OECD MC.

2.4. Specific anti-avoidance provisions in tax treaties

Portugal closely follows the OECD MC in its treaty negotiations and hence specific anti-abuse measures provided for by the model are also adopted in Portuguese tax treaties. Therefore, beneficial ownership, artiste company provisions (i.e. article 17(2) of the OECD MC) and other provisions dealing with abuse have also been included in the Portuguese tax treaty network. The reporters highlight below the key specific provisions in tax treaties signed by Portugal with its main business counterparties.

Portugal introduced, in its very first tax treaty signed with the United Kingdom in 1968, a provision in the dividends article that denied the benefit of the treaty withholding tax rates if a recipient held more then 10 per cent of the distributing company and was subject to a tax rate below 20 per cent tax "to the extent that [the dividends] can have been paid only out of profits which the company paying the dividends earned or other income which it received in a period ending twelve months or more". The recipient could nonetheless benefit from the application of the treaty rate provided it was able to prove that the holding was "acquired for bona

[23] Cf. para. 9(3) of the OECD MC commentary on art. 1.
[24] Cf. para. 9(2) of the OECD MC commentary on art. 1.

fide commercial reasons and not primarily for the purpose of securing the benefit" of the application of the treaty.[25]

As for other specific anti-abuse provisions, in the tax treaty concluded with Spain, as far as dividends, interest, royalties and capital gains are concerned, the protocol introduced a further requirement for those items of income to be treated as established in the respective tax treaty articles, aimed at counteracting treaty shopping, since the benefits would not be available "where such items of income are derived from a Contracting State by a company which is a resident of the other Contracting State the capital of which is held, directly or indirectly, for more than 50% by shareholders or members who are non-residents of that other State".[26] Notwithstanding, treaty benefits might still be granted to such a company provided it can show that it "carries on in the Contracting State of which it is a resident a substantial business activity other than a mere holding of securities or other assets". The treaty concluded with the Ukraine also includes a similar provision in the protocol.[27]

Furthermore, in the treaty with the USA a typical "limitation on benefits"[28] clause framed under the US model was accepted by Portugal, which specifically added that

> "the benefits of this Convention shall not be allowed to any person that is entitled to income tax benefits under the provisions of the legislation and other measures relating to the tax-free zones (*zonas francas*) of Madeira and Santa Maria Island, or to benefits similar to those provided with respect to such tax-free zones that are made available under any legislation or other measure adopted by either Contracting State after the date of signature of this Convention."

Furthermore, the treaty entered into with the Netherlands also contains a special provision in the protocol, which denies treaty benefits for residents that "benefit from a favourable tax treatment … in so far as domestic transactions comparable to the transactions to which this favourable tax treatment is applicable are excluded from this favourable tax treatment (ring fenced)".[29] The wording seems aimed at covering, *inter alia*, taxpayers resident in Portugal that benefit from the tax regime of the Madeira International Business Centre. However, the protocol of the treaty with the Netherlands further adds that those types of residents might still be entitled to treaty benefits if the favourable tax regime is "accepted and to the extent they are authorised by the European Community as an appropriate support for the economic development of a particular area and do not undermine the integrity and coherence of the Community legal order, including the internal market and common policies",[30] which was precisely the case for the Madeira International Business Centre owing to the EC Commission's approval of the regime until 2020.[31]

25 Cf. art. 10, no. 4 of the treaty concluded with the United Kingdom.
26 Cf. protocol §3 of the treaty concluded with Spain.
27 Cf. protocol §5 of the treaty concluded with the Ukraine.
28 Cf. art. 17 of the treaty concluded with the USA.
29 Cf. protocol § II.3 of the treaty concluded with the Netherlands.
30 Cf. protocol § II.5 of the treaty concluded with the Netherlands.
31 In the Portuguese literature it has been argued that the neutralization by the state of residence of the useful effect of an EU state aid in the form of an authorized tax incentive granted by a source state

As for capital gains, Portugal has also included in several of its treaties a provision similar to article 13(4) OECD MC allowing the taxation of gains derived from the alienation of shares deriving their value from immovable property,[32] although the reference to a specific percentage of 50 per cent was only included in five of those treaties.[33]

The treaties with Brazil, Pakistan and Venezuela expressly foresee in the scope of their respective treaty articles on "exchange of information" (e.g. article 26) the possibility of an "exchange of information regarding tax avoidance".

3. Relationship with EC law

Portuguese compliance with EC law on tax issues, and specifically where anti-abuse rules are concerned, might be defined as relatively unsatisfactory, given the infringement procedures it was subject to in the past and the infringement procedure to which it is currently subject (e.g. the Portuguese exit tax). Notwithstanding, the issue has been gaining increasing relevance domestically as the European Court of Justice (ECJ) addresses the compatibility of domestic anti-abuse rules and questions similar anti-abuse rules of other Member States. In this context the compatibility of Portuguese rules has also been brought into question.[34]

Therefore, it is not surprising that following the *Lankhorst-Hohorst*[35] decision, Portugal amended its thin capitalization rule[36] to expressly exclude its application where the lender was resident in any of the EU Member States, in order to comply with EC law requirements. The thin capitalization rule was applied in several cases where EU lenders were involved and the amendment led to a series of court decisions in favour of the taxpayer and to a specific ruling from the tax authorities clarifying that the Portuguese thin capitalization rule would not be applied where the lender was an EU non-resident.

Portugal's exit tax domestic rules have only recently been the subject of a notification of an infringement procedure by the EC Commission[37] and its decision to refer Portugal to the ECJ.[38] There has been a long-standing debate in the literature as to whether the Portuguese CFC rule might be said to be in line with ECJ case

cont.

would make the first mentioned state the beneficiary of the exemption underlying the aid and this would constitute a violation of the positive and negative obligations deriving from Community law. See Nuno de Sampayo Ribeiro, *"Tax havens", "Offshore" and "IFSCs'' within the EC: a turntable phenomenon between European Law and International Tax Law? Some thoughts*, IBFD, 1998, pp. 50 *et seq.*

32 Cf. treaties concluded with Canada, Chile, France, Guinea-Bissau, India, Ireland, Israel, Malta, Mexico, Moldova, Romania, United States, Uzbekistan, Spain, Slovenia, South Africa and Venezuela.

33 Cf. treaties concluded with Ireland, Israel, Moldova, Guinea-Bissau and Slovenia.

34 Cf. Ana Paula Dourado, Portugal in *Towards a Homogeneous EC Direct Tax Law*, ed. Cécile Brokelind, IBFD, 2007, pp. 341–356.

35 Cf. C-324/00, ECR I-11779 [2002].

36 Cf. Francisco de Sousa da Câmara and José Almeida Fernandes, "Portugal: Thin Capitalization Rules", *International Transfer Pricing Journal*, vol. 14, no. 2, 2007.

37 Cf. EC Commission IP/09/1635, dated 29 October 2009.

38 Cf. EC Commission IP/09/1460, dated 8 October 2009.

law, especially after the *Cadbury-Schweppes*[39] decision and the recent infringement procedure initiated against Spain,[40] which had a similar CFC rule to the Portuguese one and was forced to change its legislation accordingly.

As for the compatibility of domestic anti-abuse rules with EC directives, the rule denying a full participation exemption where dividends are paid by a qualifying company that is not subject to effective taxation might be questioned in light of the Parent–Subsidiary Directive. First and foremost, the rule does not define what should be perceived as required for the purposes of construing the "effective taxation" concept. Furthermore, the rule does not allow the taxpayer to present any evidence to sustain that taxation has already occurred at a lower level (e.g. tax borne by second- or third-tier subsidiaries) and that such low taxation is based on reasons other then the pursuit of tax advantages through tax avoidance structures and full entitlement to the participation exemption regime. Therefore, it remains to be seen whether the compatibility of this rule with EC Law and the Parent–Subsidiary Directive will be upheld, in particular by Portuguese courts and the ECJ's current case law on anti-abuse rules.

In 2009, the Portuguese legislator introduced two anti-abuse rules[41] on the application of the Interest and Royalties Directive, whereby the benefits of the directive would not be granted where (a) the interest or royalties payments were not arm's length compliant and (b) the majority of the capital or voting rights of the EU resident recipient of the interest or royalties was controlled, directly or indirectly, by residents of third countries, unless proof could be presented that the chain of control's main objective, or one of the main objectives, was not to benefit from the lower withholding tax resulting from the Interest and Royalties Directive regime. The first rule can be said to be a mere restatement of article 4(2) of the directive, but it is more doubtful whether the second rule can be said to be a mere implementation of article 5 ("Fraud and abuse") of the same directive, which expressly allows the application of domestic anti-avoidance rules and especially "in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse". The Portuguese rule seems to adopt the presumption that the mere fact that the EU resident recipient of the income is controlled by residents in third countries is in itself abusive and that the burden of proof is hence inverted accordingly. However, not only have such broad presumptions of abuse been subject to the unfavourable scrutiny of the ECJ, but it should also be highlighted that the freedom of movement of capital is also protected where third countries are covered by the EC Treaty (e.g. article 56). The compatibility of this anti-abuse rule will hence not only raise issues of compatibility with the Interest and Royalties Directive, but also the EC Treaty and is therefore open to debate.

39 Cf. C-196/04, ECR I-7995 [2006].
40 Cf. EC Commission IP/08/342, dated 28 February 2008.
41 Cf. art. 80, no. 6 of the Portuguese Corporate Income Tax Code.