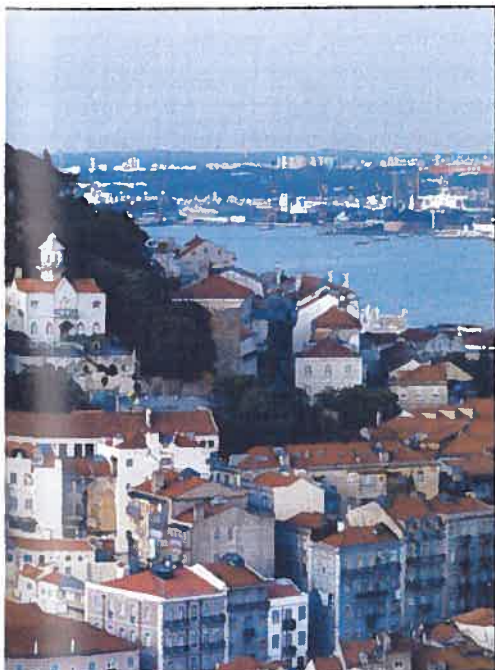


dateline Portugal

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COURT RULES ON W/H TAX ON INTEREST PAYMENTS BETWEEN PE AND GENERAL ENTERPRISE

A recent odd decision by the Portuguese Court of Appeal South (decision no. 2161/07) calls to mind the Portuguese proverb “God writes straight by curved lines.” In effect, the court misinterpreted the France-Portugal income tax treaty and failed to consider Article 12(5) (similar to Article 11(5) of the OECD model treaty), which allows the state of a permanent establishment (PE) to withhold tax on interest paid by the PE to the general enterprise.

Facts

The case involved the PE of a French bank located in Portugal that managed two leasing contracts for the construction of shopping centers in Portugal. The Portuguese tax authorities inspected the PE’s accounts and concluded that the majority of the costs incurred by the PE were interest paid to the general enterprise, and the remaining costs were current management expenses.

For the first couple of interest payments to the general enterprise, the PE withheld at the source the tax due at the reduced rate in the France-Portugal income tax treaty. For subsequent interest payments, the PE stopped withholding the tax based on the Por-

tuguese tax incentives statute, which exempts from corporate income tax the interest received by nonresident financial institutions derived from loans made to credit institutions resident in Portugal.

According to the tax authorities, this exemption did not apply because (1) the operation was not between two separate legal entities, and (2) it was not a loan but rather a mere internal transfer of funds between the general enterprise and the PE. The tax authorities further argued that the PE did not comply with the requirements for the reduced rate in Article 12(1)(2) of the treaty and that Article 7 should apply.

The PE argued that the tax authorities were misinterpreting Article 7 because the taxable profit attributable to a PE is never subject to withholding tax in Portugal and a PE should be taxed as if it were a company resident in Portugal. Further, the PE should be taxed on the profit attributable to it that corresponds to the difference between the rents from the leasing contract that were attributable to the PE and the interest charged by the general enterprise. Also, following a legal or formal approach, the flow of income between the PE and the general enterprise should not be qualified as inter-

est, but as other income that, according to Article 7, should be taxable only in the resident state. Even following a more economical approach in which the PE would be considered an independent and separate enterprise, a domestic exemption on interest received by nonresident lenders should apply because the PE should be considered a corporate body resident in Portugal. By not allowing the domestic

exemption to apply in relation to PEs of nonresident financial institutions, when the exemption is available to loans contracted between subsidiaries of financial institutions resident in Portugal and a parent company resident in another EU member state, the tax authorities were discriminating against PEs. This is expressly forbidden by Article 43 of the EC treaty (freedom of establishment).

Court of Appeal Decision

The court began with a lengthy consideration of the historical development of the substantive legal regime of financial institutions and its harmonization at the EU level, as well as of the opening of branches in Portugal of financial institutions resident in other member states. In relation to the legal status of the PE, the court stated that, for tax purposes, a PE is a separate legal entity and the profits attributable to a PE are never subject to withholding tax in Portugal; it is similar to a resident company. Further, the court ruled that the financing obtained by the PE from the general enterprise was not a loan. Therefore, the interest paid by the PE was not interest subject to withholding tax in Portugal. Judge Malheiros dissented, saying that if interest paid to the general enterprise were considered a deductible cost of the PE, it had to be considered a benefit of the general enterprise. Accordingly, the interest should be subject to withholding where an exemption does not apply.

Analysis

Despite the misinterpretation of the treaty, the decision is correct, not because internal transfers from a general enterprise to a PE cannot be considered loans, as they are made within the same legal entity and therefore the payments from that internal transfer cannot be considered interest subject to withholding tax, but because there is a domestic exemption. Although this exemption was drafted for interest paid by resident credit institutions to nonresident financial institutions, at least in an intra-EU context, under the nondiscrimination principle in the "freedom of establishment" provision (or even in relation to third countries under the "free movement of capital" rules), the exemption should apply to interest paid by a PE located in Portugal to a general enterprise that is also considered a financial institution. ●

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