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ECJ Examining Portugal's Taxation Of Foreign Pension Funds

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COUNTRY DIGEST

ECJ Examining Portugal's Taxation of Foreign Pension Funds

A judgment by the European Court of Justice is the next step in *European Commission v. Portuguese Republic* (C-493/09), now that Advocate General Paolo Mengozzi has issued his opinion that Portugal's taxation of foreign pension funds constitutes an unjustified restriction on the free movement of capital in violation of article 63(1) TFEU[1] and article 40 of the European Economic Area Agreement.

The European Commission in December 2009 challenged a Portuguese law that exempts dividends paid to Portuguese pension funds from corporate tax[2] while subjecting dividends paid to foreign pension funds to tax rates ranging from 10 to 20 percent.[3] (For the text of the action brought against Portugal by the European Commission in Case C-493/09, see *Doc 2010-2177* or *2010 WTD 20-16*.)

Portuguese Law

According to Portugal's Corporate Income Tax Code (article 4), nonresident corporate bodies are subject to corporate income tax on income obtained in Portugal. Dividends paid by entities resident in Portugal to nonresident shareholders are considered to have been obtained in Portugal.

According to article 87(4)[4] of the tax code, those dividends are subject, as of January 1, 2011, to withholding tax at a rate of 21.5 percent,[5] or to the lower rate foreseen in the relevant income tax treaty.

Article 97(2)[6] clarifies that dividends paid to resident pension funds are not subject to withholding tax provided that the payer of the dividends is notified of the exemption.

Further, according to a rule designed to combat dividend stripping practices, dividends paid by resident entities to corporate bodies that are totally or partially exempt from corporate income tax (as is the case with resident pension funds) are subject to corporate income tax at the rate of 20 percent if the shareholding was not held, without interruption, during the year prior to distribution and will not be held during the time frame necessary to complete that one-year period.

The European Commission argued that the difference in the Portuguese tax treatment of dividends paid to domestic and foreign pension funds makes investment by foreign funds in Portuguese companies less attractive and therefore constitutes a restriction that is not justified by any overriding reason of public interest presented by the Portuguese government.

Advocate General's Opinion

In his May 25 opinion, Mengozzi set aside a preliminary objection raised by Portugal, which maintained that the form of order sought by the European Commission is too broad because in some cases, dividends paid to Portuguese pension funds are also subject to corporate income tax at the rate of 20 percent (in accordance with the dividend stripping rule).

The advocate general then analyzed the two justifications presented by Portugal. In its first justification, Portugal presented a flexible interpretation of the cohesion principle, stating that the exemption for pension funds resident in Portugal is offset by the taxation of the pensions paid to beneficiaries resident in Portugal.

For Portugal it is inherent to the scope of the tax regime that the exemption apply only to resident pension funds, because in a global context the pensions

[1]The Treaty on the Functioning of the European Union.

[2]Article 16(1) of the Tax Benefits Statute.

[3]Article 16(4), which states that the exemption does not apply to pension funds that are not constituted and operating in accordance with Portuguese law, and that the pension fund management company in such cases is primarily responsible for payment of the tax due.

[4]Previously article 80(4).

[5]Previously 20 percent.

[6]Previously article 90(2).

taxed afterward in the beneficiaries' hands are composed essentially of the investments and income generated by the pension funds resident in Portugal.

Mengozzi did not agree with that argument. He held that the cohesion of the Portuguese tax system would not be endangered if the exemption were extended to nonresident pension funds. On the contrary, the cohesion of the tax system would be reinforced if the exemption were extended to nonresident pension funds, because otherwise, resident taxpayers that receive pensions from nonresident pension funds would be subject to double taxation.

Moreover, Portugal was not able to justify why in some cases — namely, when pension funds receive dividends from shareholdings held for a period of less than one year — both resident and nonresident pension funds are taxed at the 20 percent rate.

Finally, Portugal justified the restriction on the free movement of capital based on the need to guarantee the effectiveness of fiscal supervision. Portugal argued that Portuguese pension funds are not only subject to the strict rules of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, but also to additional requirements foreseen in Portuguese law, especially in relation to financial responsibility. Moreover, the tax responsibility foreseen in article 16(4) of the Tax Benefits Statute cannot be activated in case of nonresident pension funds, it said.

The European Commission, however, said that position should be rejected. The Portuguese regime does not allow nonresident pension funds the opportunity to prove that they offer guarantees equivalent to resident pension funds. For that purpose, it would suffice to demand that nonresident pension funds present proof of their capacity and the legal framework within which they operate, the commission said. Moreover, the mechanisms of cooperation and mutual assistance in EU law and in multilateral and bilateral agreements in relation to EEA states allow the Portuguese authorities to proceed with any possible verifications and even collect tax debts, it said.

Mengozzi agreed with the commission's argument, citing several instances of case law on the topic.[7] Further, he held that pension funds established in EEA states are also subject to the provisions of Directive 2003/41/EC.[8]

Portugal and the European Commission also debated whether Directive 77/799/EEC concerning mutual assistance by the competent authorities of the EU member states in the field of direct taxation and the taxation of insurance premiums was applicable in the case at issue in relation to information connected with Directive 2003/41/EC.

In Mengozzi's opinion, Directive 77/799/EEC is not the most suitable instrument to obtain the information required by Portuguese law, and it does not apply to EEA states. However, this is not sufficient to justify the restriction on the free movement of capital. According to paragraphs 132 and 133 of the ECJ judgment in *Haribo Lakritzen Hans Riegel* and *Österreichische Salinen* (joined cases C-436/08 and C-437/08),[9] Portuguese law does not foresee the possibility of an exemption for dividends received by pension funds resident in states that are party to the EEA Agreement when there is an exchange of information clause with those states.[10]

Finally, Mengozzi was also unconvinced by Portugal's argument that if the requirements to benefit from the dividend exemption are not fulfilled, the pension fund management company will be rendered primarily responsible for the payment of the tax due, and that in the case of nonresident management companies, it would be impossible to collect the tax.

According to the advocate general, the collection of tax debts is not related to the effectiveness of fiscal supervision. Further, the Portuguese tax authorities may use the mechanisms foreseen in Directive 2008/55/EC on mutual assistance for the recovery of claims relating to certain levies, duties, taxes, and so on in relation to other EU member states. Although that directive does not apply to states that are party to the EEA Agreement, the absolute prohibition to benefit from the tax exemption is in any case disproportionate, Mengozzi said. Other less restrictive measures could have been introduced in Portuguese law to ensure the collection of tax debts — namely, demanding financial guarantees or the creation of a regime that allows the tax authorities to collect tax debts by way of a withholding on the future results of the Portuguese company held by the nonresident pension fund. Consequently, Mengozzi held that Portuguese law constitutes an unjustified restriction on the free movement of capital.

Taking into consideration previous case law, it is probable that the ECJ will follow Mengozzi's reasoning and rule against Portugal in this case. ◆

♦ *Bruno Santiago, Morais Leitão, Galvão Teles, Soares da Silva e Associados, Lisbon*

[7]Including *Laboratoires Fournier* (C-39/04), paragraph 25 (*Doc 2005-4967*, *2005 WTD 47-6*), and *ELISA* (C-451/05), paragraph 96 (*Doc 2007-23006*, *2007 WTD 199-16*).

[8]The application of this directive has been extended to Iceland, Liechtenstein, and Norway by the EEA Joint Committee Decision No. 86/2006 of July 7, 2006, amending Annex IX (Financial Services) to the EEA Agreement.

[9]*See Doc 2011-2905* or *2011 WTD 29-18*.

[10]The commission has evidenced that such clauses exist in relation to Norway and Iceland.