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FEATURED PERSPECTIVES

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The Portuguese Tribunal Central Administrativo-Sul has recently referred to the European Court of Justice a case dealing with the application of Portuguese thin capitalization rules that denied the deductibility of interest due from a loan provided by a related corporation resident in a third country, because such interest resulted from so-called excessive debt (that is, over the 2-1 debt-to-equity ratio). The case, *Fazenda Pública v. Itelcar — Automóveis de Aluguer, Lda* (C-282/12), is interesting, and it might prompt the ECJ to revisit the issue of the entitlement of residents of third countries to claim the freedom of capital as a barrier to the application of discriminatory tax rules, but also the issue of the application of transfer pricing's arm's-length test as a basis for justification for the application of specific discriminatory tax rules only in a cross-border situation and, more broadly, discuss the relevance of the distinction between debt and equity for tax purposes.

The facts of the case are particularly straightforward: A Portuguese resident corporation (Itelcar) received a loan from a related corporation resident in the U.S. (GE Capital). The Portuguese thin capitalization rules establish that interest payments may not be deducted from taxable income if these payments exceed in the taxable period twice the share capital participation held by the nonresident corporation. The Portuguese rules merely result in nondeductibility of the interest and there is no reclassification of such income. Further, the rule is only applicable to indebtedness to lenders resident in third countries. Itelcar was in an ''excessive debt'' position in fiscal years from 2004 to 2007 and following a tax audit, the tax authorities deemed that the interest arising from the excessive debt was not deductible in those years, which led to additional tax assessments.

Also, the Portuguese thin capitalization rules allow for a taxpayer in such a situation to present proof that it would be able to obtain the same level of borrowing under similar circumstances by an unrelated party. In such cases, the taxpayer bears the burden of proof. Along with its tax documentation, Itelcar prepared and filed a statement claiming that it was able to obtain a similar borrowing by presenting an independent bank estimate for granting a similar loan, as well as presenting in its transfer pricing documentation a study allegedly evidencing that Itelcar's borrowing to its related enterprise was an arm's-length indebtedness within the taxpayer's industry. However, neither the tax authorities nor the first instance court accepted Itelcar's claim and found that the burden of proof was not fulfilled by the taxpayer.

After the tax authorities issued an additional assessment for the fiscal years from 2004 to 2007, Itelcar filed an administrative claim and later a judicial appeal. Itelcar claimed that the tax assessments were illegal on several grounds, notably by contending that the Portuguese thin capitalization rules were contrary to articles 63 and 65 of the Treaty on the Functioning of the European Union (TFEU) in what concerns its application to indebtedness of Portuguese taxpayers to lenders resident in a third country. The first instance court claimed that such an assertion was not sustainable, because the applicable freedom in this case was the freedom of establishment (and not the freedom of capital), which does not demand that member states prevent any discrimination regarding the establishment of its nationals outside the EU or the establishment of nationals of third countries in a member state. Consequently, it concluded member states are not prevented from applying the thin capitalization rules to third countries.

Itelcar appealed from the first instance court to the Tribunal Central Administrativo-Sul and claimed that the first instance court had erred on its assessment of the compatibility of the Portuguese thin capitalization rules with the TFEU by claiming that both the freedom of establishment and the freedom of capital were capable of being applicable. The Tribunal Central Administrativo-Sul, judging on appeal and typically on a final basis, decided that it should submit to the ECJ a question — exactly on the same terms as suggested by the taxpayer — as follows:

> Do Articles 63 TFEU and 65 TFEU (Articles 56 EC and 58 EC) preclude legislation of a Member State, such as that contained in Paragraph 61 CIRC (Código do Impostosobre o Rendimento das Pessoas Coletivas) in the wording resulting from [Decree-Law No.] 198/2001 of [July 3, 2001], as amended by [Law No.] 60 A/2005 of [December 30, 2005] (State Budget Act for 2006), which, in connection with the indebtedness of a taxable person residing in Portugal to an entity of a non-member country with which it maintains special relations within the meaning of Paragraph 58(4) CIRC, does not allow the setting off against tax of interest relating to the part of its indebtedness regarded as excessive under Paragraph 61(3) CIRC, borne and paid by a taxable person residing within national territory on the same basis as interest borne and paid by a taxable person residing in Portugal who is found to be excessively indebted to an entity residing in Portugal with which it maintains special relations?[1]

The case might again prompt the ECJ to discuss the issue of the applicable freedom in testing the compatibility of thin capitalization rules, which was first addressed by Advocate General Leendert Geelhoed in his opinion in the *Thin Cap GLO* case (C-524/04), which stated that the eventual restriction of the free movement of capital is ''purely an indirect consequence'' of the exercise of the freedom of establishment and hence that the ''UK legislation at issue should only be considered for compatibility with Article 43.'' The ECJ followed the AG opinion in that case and also reaffirmed that same view later on a reasoned order in what concerns the application of German thin capitalization rules to third countries in *Lasertec* (C-492/04). The same decision might be taken by the ECJ in *Itelcar*, especially if it considers that the answer may be clearly deduced from the existing case law quoted above.

However, the ECJ approach of looking to the aim of the legislation as decisive to determine, in third-state situations, whether a case should be judged under one or another treaty freedom might merit a better analysis of the Portuguese thin capitalization rules and this case by the ECJ. In *Thin Cap GLO* and *Lasertec*, thin capitalization rules have been construed as addressing ''groups of companies, i.e. holding relations of effective control'' and consequently leading to capital movements being ''considered entirely subordinate to establishment.''[2] The Portuguese thin capitalization does not exactly fit the mold as the rules are triggered immediately when there are special relations between enterprises, which occurs, for instance, with a mere holding, directly or indirectly, of more than 10 percent. Therefore, it is doubtful whether in all cases a decisive influence is required for the Portuguese thin capitalization rules to apply, which might lead to the assertion that its aim does not always imply a notion of control. Moreover, this case might represent an opportunity for the ECJ to view the current jurisprudence regarding the application of the freedom of capital movements to residents in third countries.

Factually, in the *Itelcar* case, the U.S. lender (GE Capital) did not have a direct shareholding in Itelcar, although it owned an EU intermediate holding company that in turn held Itelcar's share capital. Therefore, an actual decisive influence can be said to exist indirectly in *Itelcar*, but is the ECJ analysis on which fundamental freedom is applicable based solely on the aim of the rule in itself or rather taking into account its concrete application to a determined set of facts?

The fact that the question submitted to the ECJ does not highlight any of these specific aspects of the Portuguese thin capitalization rules might lead the ECJ to merely reaffirm its standing case law on application of thin capitalization rules to third countries on the basis of the *Thin Cap GLO* and *Lasertec* precedents.

If the ECJ were to proceed with the analysis of the case on the basis of the discriminatory nature of its application in third-country situations, one interesting topic that might be raised would include the transfer pricing perspective and whether it is justified that the denial of deductibility on the basis of the indebtedness of Itelcar is not being considered arm's-length compliant.

The issue was first dealt with specifically regarding the application of thin capitalization rules in *Lankhorst-Hohorst* (C-415/93), in which the ECJ rejected that its application only on a cross-border transaction was acceptable. However, in *Thin Cap GLO* the ECJ seemed open to accept an arm's-length test as a ''test of objective artifice'' that failure to pass would sustain the application of transfer pricing rules only in a cross-border

[1] *See* OJC 250, Aug. 18, 2012, p. 90.

[2] Ben J.M. Terra and Peter J. Wattel, *European Tax Law* (Sixth Ed.), Kluwer Law International, p. 78.

scenario as proportional, provided the taxpayer is granted the opportunity, without being subject to undue administrative constraints, to demonstrate commercial justification for the arrangement. Later, in *SGI* (C-311/08), the Court further accepted that the application of transfer pricing rules could not apply on purely domestic cases but merely on cross-border cases. However, it seems that such finding highly leaned on the fact that the initial burden of proof was on the tax authorities.

The Portuguese transfer pricing rules allow for a taxpayer to prove that it was able to obtain the same level of borrowing under similar circumstances by an unrelated party. However, the burden of proof is automatically shifted to the taxpayer when the 2-1 debt-to-equity ratio is surpassed. The facts of *Itelcar* also highlight the difficulty in fulfilling that burden of proof, as the tax authorities and the first instance court rejected a series of documents and estimates presented by Itelcar in sustaining its claim that the borrowing was arm's-length compliant. Following the reasoning in *SGI*, it is highly uncertain whether the mere fact that reaching a certain threshold of debt might be considered indicative of the artificial nature of a borrowing to have the burden of proof shifted to the taxpayer, and as a result this issue merits further guidance from the ECJ, namely considering the most recent jurisprudence on proportionality.

On a tax policy perspective, the use of thin capitalization rules appears to raise the need to further debate the debt-equity issue, which seems to be at the heart of this type of rule. The implicit assumptions seem to be that a corporation should be financed for tax purposes using some sort of standard ratios of debt and equity, which leads to the conclusion that if thresholds are surpassed then debt would be treated as equity and hence not deductible. However, it is unclear whether the use of this type of rule entails further distortions to the corporate tax system in how it deals with debt and equity, especially since it applies to a purely cross-border scenario.

In spite of the ECJ decision, the Portuguese Tribunal Central Administrativo-Sul should still consider whether the burden of proof referred to above was fulfilled by the taxpayer on the basis of the evidence previously presented and also on the possible application of the nondiscrimination principle foreseen in the Portugal-U.S. income tax treaty. ◆