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by Francisco de Sousa da Câmara

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Thin Capitalization Rules Violated EC Treaty, Lisbon Court Says

by Francisco de Sousa da Câmara

The tax and administrative court of Lisbon has ruled that Portugal's thin capitalization rules in place before 2006 violated articles 6, 43, 49, and 56 of the EC Treaty and that the new rules still do not adhere to the arm's-length principle. The decision was issued on July 26 but did not become binding until September.

The thin capitalization rules were introduced in 1996 to restrict the deductibility of corporate interest paid to foreign companies. They were introduced together with other antiavoidance provisions, such as rules that deny the deductibility of fees paid to entities located in low-tax jurisdictions.

The thin capitalization rules established that when a nonresident entity directly or indirectly held at least 25 percent of the capital of a resident corporate entity, that portion of the interest payments that exceeded a debt-to-equity ratio of 2 to 1 at any moment of the taxable period would be nondeductible.

However, that ratio could be disregarded if the resident company could prove within 30 days of the end of the taxable period that the transaction respected the arm's-length principle based on specific criteria, such as the type of activity or the turnover of the company.

The Facts

The case involved a Portuguese subsidiary of a Danish company during 1999 and part of 2000 and, subsequently, a Dutch parent company. Both parents held 99.9 percent of the Portuguese subsidiary, and they belonged to the same economic group, which manufactured calcium and carbon byproducts.

To carry out its activity, the Portuguese subsidiary was required to obtain additional funds apart from its equity. That it had only recently begun operating in the Portuguese market and was almost in its start-up period created some additional difficulties for the company in obtaining capital, unless the international group would guarantee the loan.

The group also included a financial entity in Ireland, so the Portuguese subsidiary decided to enter into a loan contract with that company, under which it was agreed that:

- the lender would lend the borrower an advance, for a period of 1, 3, 6, or 12 months or such other terms as may be mutually agreed in writing, in multiples of €1,000;
- the aggregate amount outstanding under the loan would not exceed €5 million;
- the loan would be granted for the period from January 1, 1999, to December 31, 1999, after which it would automatically be extended for one year if not revoked by either party with 30 days prior written notice; and
- the borrower would pay interest on each advance drawn down or renewed under the loan on its maturity date at the London Interbank Offered Rate (LIBOR) plus a margin to be negotiated between the parties no later than the second banking day before the drawdown or renewal date of the advance.

Before entering into that agreement, the Portuguese subsidiary considered other loan proposals presented by Citibank and another Portuguese bank. On the date of the first drawdown, the indicative interest rate given by the group finance company was 4.91 percent, while the Citibank interest rate was 4.3 percent. But the latter proposal had more limitations in terms of periods and guarantees to be presented by other group companies, and

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involved the payment of commissions. The Portuguese bank also presented a proposal with an interest rate slightly higher than the one established in the contract with the Irish lender.

Considering all the facts, the subsidiary's directors decided to sign the loan contract with the group's Irish financial company. At the same time, they informed the tax authorities that the 2-to-1 debt-to-equity ratio had been exceeded, justifying the situation in accordance with the facts and the law.

This was one of the first cases, if not the first, with those nuances, and the tax authorities decided to initiate a tax inspection. At the end of that inspection, they concluded that the evidence provided by the taxpayer to justify exceeding the ratio was not sufficient to prove that the arm's-length principle had been respected, and subsequent tax assessments were made.

No other comparisons or justifications were presented. The difference in interest rates provided by the Irish lender and Citibank, combined with the verification of the two main criteria defined in the law to prevent the deductibility of interest, provided grounds to justify the tax assessments.

Legal Arguments and Decision

The Portuguese subsidiary immediately cited the incompatibility of Portugal's rules with EU law and with the tax treaty between Ireland and Portugal.

Even before the European Court of Justice delivered its judgment in *Lankhorst-Hohorst* (C-324/00) (for the judgment, see *2002 WTD 241-23* or *Doc 2002-27361*), it was already clear, based on other EC jurisprudence, that "although direct taxation falls within their competence, Member States must nonetheless exercise that competence consistently with Community law and, in particular, avoid any discrimination on grounds of nationality." The restriction in Portuguese law allowed a difference in the treatment of resident subsidiary companies based on whether their parent company had its seat in Portugal. That difference in treatment was contrary to EU law, as illustrated by the *Lankhorst-Hohorst* judgment.

The Lisbon Tax Court pointed out that EU law forbids discriminatory treatment based on nationality, including indirect discrimination related to residence. In the case at issue, the court found that there was no justification for a difference in the treatment of debt paid to residents or nonresidents. Therefore, it held that article 57-C of the Corporate Tax Code (CIRC) violated article 43 (on freedom of establishment) of the EC Treaty.

The court also found the Portuguese provision to be in violation of article 56 (on the free movement of capital) of the EC Treaty and also unjustifiable as arbitrary discrimination. The court held that article 57-C CIRC did not respect the arm's-length principle in that the nondeductibility of interest was not limited and justified by reference to transactions entered into between independent entities, but by the fact that the 2-to-1 debt-to-equity ratio was exceeded and that corrections were made in relation to the interest paid in excess of that ratio.

Furthermore, because the Portuguese legal provision also introduced restrictions on nonresidents that intend to provide services to resident entities, the court held that the provision is in violation of article 49 (on the freedom to provide services) of the EC Treaty. In reaching that conclusion, it cited the ECJ jurisprudence in *Safir* (C-118/96).

In summary, the court held that:

- article 57-C CIRC was contrary to articles 6 (on fundamental rights), 43, 49, and 56 of the EC Treaty;
- considering the violation of EU law, it was not necessary to analyze other potential illegalities raised by the taxpayer (namely, the violation of the tax treaty between Portugal and Ireland); and
- the tax corrections and assessments challenged by the taxpayer were considered void.

Final Remarks

Just before the July 26 decision in the case, the Portuguese authorities — anticipating the result — decided to amend the thin capitalization rules. In fact, since January 1, 2006, the rules have applied only to non-EU residents (current article 60 CIRC), although they still can be applied automatically. Moreover, in 1996, the 25 percent ownership requirement was replaced with what the law refers to as a "special relationship" requirement, which allows the antiavoidance rule concerning thin capitalization to apply if a nonresident has a mere 10 percent ownership in the resident entity.

In that context, the lack of analysis concerning the compatibility of Portugal's thin capitalization rules with its tax treaties (particularly those that include a provision similar to article 24(4) of the OECD model income tax treaty, such as the one concluded with Ireland) prevented the market from obtaining legal guidelines in that respect. However, in its decision, the court held that the rules do not respect the arm's-length principle. Therefore, it still remains to be seen whether the current thin capitalization regime will be found to be compatible with Portugal's tax treaties. ◆

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