Portugal

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Thin Capitalization Rules

In 1996, Portugal introduced thin capitalization provisions that would deny the deductibility of interest if the debt:equity ratio of the borrowing company exceeded 2:1. This article describes the Portuguese thin capitalization rules, their development over time and how they relate to EC Treaty law.

1. Introduction

Identification of the best means of financing a business structure is an essential aspect of any project or investment. Under Portuguese law, in addition to general options such as leasing and factoring transactions and the issuance of bonds, companies finance their activities and obtain funds in the form of (1) capital contributions (i.e. as equity to incorporate a company or as a subsequent increase of paid-in capital) (2) supplementary contributions of capital[1] that are not interest bearing and (3) borrowing, with shareholder loans and bank loans being the most common means of financing.[2] Recently, major companies have made use of hybrid financing in the form of convertible loans, subordinated loans and profit participating loans. Both types of capital contributions (i.e. paid-in capital and quasi-equity contributions, *prestações suplementares*) are registered as equity and the debt is recorded as a liability.

As a rule, interest from debt is deductible for corporate income tax purposes. Conversely, dividends from equity and refunds of quasi-equity are not deductible. This distinction serves to encourage companies to increase debt so as to reduce their taxable income. In light of this situation and following an international trend, in 1996 Portugal introduced thin capitalization provisions that would deny the deductibility of interest if the debt:equity ratio of the borrowing company exceeded 2:1. This measure was introduced along with several other rules intended to introduce restrictions on the deduction of expenses, costs and capital losses in order to prevent erosion of the taxable base.

The general corporate income tax regime provides for two other rules that are relevant in this context. First, expenses (including interest) are deductible to the extent that they are essential for the gaining or producing of taxable income or for the maintenance of the source thereof. In this regard, it is not unusual for there to be additional tax assessments following a tax audit, due to the disallowance of an interest deduction on the grounds that the company had enough equity and did not require such loan. Such assessments often lead to litigation by the taxpayer on the grounds that the tax authorities may not intervene in the management of a company and may not place themselves in the position of directors in deciding the proper level of financing.

The second rule is that interest on loans granted by a shareholder to the company is not deductible in the amount that it exceeds by more than 1.5% the prevailing Euribor rate for 12-month loans. This limitation does not apply to loans that conform with transfer pricing rules.

2. Thin Capitalization Rules

2.1. Capital: minimum amount of equity

Portuguese law requires that the major forms of capital-oriented entities (i.e. joint-stock companies (*sociedades anónimas*, SA) and limited liability companies (*sociedades por quotas*, Lda)) must have a minimum paid-in capital. The minimum capital of a join-stock company (where the capital is divided into shares) is EUR 50,000, while for limited liability companies the minimum capital is EUR 5,000.

Company law does not contain any general rules on debt:equity ratios, except for financial entities (specifically banks and insurance companies).

2.2. Main rule

Initially, the thin capitalization provisions provided that when a non-resident entity held, directly or indirectly, at least 25% of the share capital of a resident entity, or if that entity exercised effective management or control (directly or indirectly) over the resident entity, interest payments would not be deductible from taxable income if they exceeded, in the taxable period, twice the share capital participation held by the non-resident entity.

These rules were clearly discriminatory and violated the EC Treaty. In fact, ten years later the Lisbon Tax Court confirmed this on 26 July 2006.[3] Therefore, towards the

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1. This refers to *prestações suplementares*. Corporations (SAs) may not request such contributions, but may ask for contributions of a similar nature. Analysis of this was made in 1996 by Rui Pinto Duarte, "A Subcapitalização das Sociedades no Direito Comercial", March 1996.
2. It is important to note that subsequent increases of capital, contrary to contributions of supplementary contributions of capital or borrowings are subject to stamp duties. Currently, taxpayers are challenging whether these duties are in conformity with EC Law. See case C – 366/05, pending in the ECJ.
3. This was pointed out in several articles published during these ten years, such as: (i) Glória Teixeira, "Thin Capitalization in the Portuguese Tax System", *Intertax* 1996/12, at 472 and *Intertax* 1997/2, at 61; (ii) Manuel Anselmo Torres, "Alcance do novo regime fiscal da subcapitalização de empresas", *Fisco* 76-77, at 75; (iii) Patrícia Noiret Silveira da Cunha, "A subcapitalização no Direito Português", *Estudos em Homenagem ao Professor Doutor Pedro Soares Martínez*, ed. Almedina, 2000; (iv) Paulo de Pitta e Cunha e Luís Máximo dos Santos, "Sobre a incompatibilidade com o direito comunitário do regime fiscal da subcapitalização", *Fisco* 119-121, n.º 3 *et. Seg.* See also the Portuguese report for IFA 1996, by Maria dos Prazeres Rito Lousa.

end of those judicial proceedings, the government sought to change the rule, which currently provides as follows:

> When a non-EU resident lends funds to a resident entity with which it has a "special relationship", as defined by Art. 58 nº 4 of the Corporate Income Tax Code (CIRC), 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 non-resident entity.[4]

In order to determine whether this rule applies and, if so, how it applies, it is necessary to determine (1) the meaning of "special relationship", as defined by Art. 58 nº 4 of the CIRC, (2) the relevant concept of equity and (3) the relevant concept of debt. In addition, it is worth determining how and when can one challenge the presumed disallowance of interest deductions, i.e. how a taxpayer can prove that its debt:equity ratio respects the ratio that would have been obtained by an independent entity in the same circumstances, such that the deduction should be allowed.

2.3. Concept of "special relationship"

Under Portuguese law, a special relationship is deemed to exist between two entities where one may exercise, directly or indirectly, a significant influence on the management decisions of the other, specifically between:

- an entity and its respective shareholders,[5] as well as the spouses, ascendants and descendants thereof which hold, directly or indirectly, a participation of at least 10% of shares or voting rights;
- entities in which the same shareholders, respective spouses, ascendants or descendants hold, directly or indirectly, a participation of at least 10% of shares or voting rights;
- an entity and the members of its executive bodies, namely the board of directors (regardless of title), financial supervisory board and respective spouses, ascendants and descendants;
- entities in which the majority of the members of the board of directors or of the financial supervisory board are the same person or, although different, are related by reason of matrimony, legally recognized union or direct descent;
- entities linked by a contract of subordination (where the management of a company is subordinated to the direction of another company, which may or may not dominate the former), contract of parity (where two or more companies not dependent on each other nor on other companies, create a group of companies under an agreement by which they submit to a sole and common management) or other contract of equivalent effect;
- companies that are in a dominance relationship[6], as the latter is defined in legal documents imposing the obligation to prepare and publicize consolidated financial statements;
- entities which, because of existing commercial, financial, professional or legal relations (directly or indirectly established or practised), are in a situation of dependence in the exercise of the relevant activity, specifically where:
  - the exercise of the activity of one entity depends substantially on the license of industrial or intellectual property, or know-how, owned by the other;
  - the acquisition of raw materials or access to sales channels for goods, markets or services for one entity depends substantially on the other;
  - a substantial portion of the activity of one can be realized only with the involvement of the other or depends on decisions of the other;
  - the right to fix prices (or decisions of equivalent economic effect) relating to goods or services sold, rendered or acquired by one entity is, by contractual terms, dependent on the other entity; and
  - under the terms and conditions of their commercial or legal relationship, one entity can influence the management decisions of the other, as a result of facts or circumstances outside the scope of a commercial or professional relationship; and
- a resident or non-resident entity with a permanent establishment in Portugal and an entity subject to a preferential tax regime located in a jurisdiction included in the list approved by a decree of the Minister of Finance.[7]

Moreover, a special relationship is deemed to exist between a non-EU resident entity and a resident borrower where the former received a guarantee from an entity with a special relationship with the borrower. This situation covers back-to-back loans.

In calculating the percentage of indirect share participation or voting rights mentioned above, in situations where there are no specifically defined rules, the criteria specified in Art. 483(2) of the Commercial Companies Code must be followed.

2.4. Relevant equity

Obviously, the definition of equity is essential to determining the debt:equity ratio. This concept does not correspond exclusively to paid-in capital, but to the accounting concept of equity (*capital próprio*), which includes share capital (to the extent paid up), quasi-equity (capital contributions that may be refunded in specific circumstances before dissolution), share premiums, own-share reserves, retained earnings, net income from the current tax period and eventual interim dividends. In any case, equity is not affected by potential capital gains or losses, including those resulting from "free revaluations" or by application of the equity method (*aplicação do método da equivalência patrimonial*). This means that the book value of a company's assets is considered, while hidden reserves are not taken into account.

4. Article 61º n.º1, Corporate Income Tax Code.
5. Shareholders include all stakeholders or partners of commercial companies. The same applies to other items in which reference is made to the term "shareholders".
6. I.e., one company controls at least 90% of the other.
7. I.e. the black list that identifies offshore jurisdictions.

2.5. Relevant debt

In calculating debt, one must take into consideration all types of loans granted to the company, in cash or in kind, regardless of the type of remuneration agreed with the entity with which the resident entity has a special relationship, including credits resulting from commercial transactions that are more than six months past due.

2.6. Timing issues

Portuguese law requires that the excess debt (considering both equity and debt) in relation to each non-resident entity be determined at each moment in time during the tax period.[8] Although absurd, the law refers to "each date during the tax period", which suggests the need for a daily approach. This makes the process very difficult for both taxpayers and tax authorities to manage and supervise.

3. Procedure to Adopt in order to Deduct Interest in a Thin Capitalization Situation

Since the inception of the transfer pricing rules in 1996, a resident company caught exceeding the 2:1 debt:equity ratio would be unconditionally prevented from deducting the excess interest paid. However, as a result of amendments to the rules, a specific procedure was introduced for a taxpayer to be able to prove that it did not violate the arm's length principle. Currently, the taxpayer bears the burden of proof to show that the same level of borrowing would also be granted under similar circumstances by an unrelated party. Thus, provided that the lender is not located in a low-tax jurisdiction (euphemistically "offshore"), the taxpayer may present evidence that it could have obtained the same level of debt under identical circumstances from an independent entity, notably considering the relevant type of activity and sector (e.g. agriculture, industry or services), scope and other relevant criteria considering the risk of such transactions.

This proof must be documented and included in the relevant data and documentation prepared each year by the taxpayer for its own files, up until the end of June. If the tax authorities do not accept the taxpayer's evidence (as a rule, following a subsequent tax audit), they will make an additional tax assessment plus compensatory interest and penalties. In such case, the taxpayer can react against the decision of the tax authorities in order to prove that the tax authorities' decision is unjustified in terms of the legal grounds, the calculations presented or formal reasons.

4. Principle of Non-Discrimination: Evidence that Portuguese Regime Is Illegal

The *Lankhorst-Hohorst* case made it very clear that freedom of establishment[9] must be interpreted as precluding measures that provide for differences in treatment of interest paid to resident and non-resident entities. These discriminatory rules against non-residents with regard to payments made to non-EU residents limit their ability to exercise the freedom of establishment, causing them to refrain from acquiring, creating or maintaining a subsidiary in a country that adopts such discriminatory rules.[10]

In addition domestic thin capitalization provisions can be challenged or even overridden by applicable treaty provisions. In this context, taking the OECD Model Treaty as a reference, Arts. 9, 10, 11, 23, 24 and 25 should be scrutinized with specific attention. Art. 24(4) of several (but not all) Portuguese income tax treaties provides that the source state must allow a deduction for interest paid by a resident of the source country to a resident of the other country, under the same conditions that would have applied if the amounts had been paid to a resident of the source country.

The thin capitalization provisions are compatible with Art. 24(4), provided that they can be justified under Art. 9(1) or Art. 11(6) and that the rules apply both to resident and non-resident lenders. However, as discussed below, if these requirements are not met, the Portuguese thin capitalization provisions[11] may be scrutinized and challenged based on Art. 24(4) of the applicable treaty. In addition, it is also possible that the proper treaty or protocol will provide otherwise. For example the protocol to the Portugal-Spain income tax treaty expressly states that the contracting states agree that, with regard to Art. 24, the treaty does not prevent either of the states from applying its domestic legislation concerning thin capitalization and excessive debt.[12]

5. Lisbon Tax Court Decision on Thin Capitalization Rules

On 26 July 2006, the Lisbon Tax Court issued a landmark decision on the legal validity of the thin capitalization provisions, notably with regard to whether such provisions comply with both EU law and the arm's length principle as established in Portuguese tax law and income tax treaties.

The case involved a wholly owned Portuguese subsidiary of a Danish company, both of which were part of a multinational enterprise. The group's associated enterprise with treasury functions resident in Ireland provided the Portuguese subsidiary with an intercompany loan. The Portuguese subsidiary requested several quotes from unrelated parties for the same loan, which for a comparable loan would place the Irish associated enterprise's interest rate within the arm's length range. Subsequently, the Portuguese subsidiary entered into the intercompany loan and because the debt:equity ratio was exceeded, duly submitted to the tax authorities adequate proof that the loan nevertheless complied with the thin capitalization provisions.

8. Article 61° n.° 3, Corporate Income Tax Code.
9. Art. 43 EC and note14.
10. C-324/00, 12 December 2002, Para. 32.
11. Art. 61° CIRC.
12. Para. 4 of the protocol to the Portugal-Spain income tax treaty.

Following a tax audit of the 1999 and 2000 fiscal years, the tax authorities concluded that the evidence provided by the taxpayer was insufficient and thus disallowed the deduction of the interest paid on the capital loaned that exceeded the legal debt:equity ratio. The Portuguese subsidiary appealed, inter alia,[13] arguing that the thin capitalization provisions violated EU law because they treated in a discriminatory fashion non-resident taxpayers resident in an EU Member State (e.g. in this case, the subsidiary's Irish associated enterprise).

During the Portuguese court proceedings, the European Court of Justice (ECJ) rendered its decision on the *Lankhorst-Hohorst* case,[14] upon which the Lisbon Tax Court relied in concluding that EU law forbids discriminatory treatment based on nationality, including indirect discrimination related to residence.[15] As the Court found that there was no justification for such a difference in the treatment of debt paid either to residents or non-residents, it held that the then Art. 57-C of the CIRC violated Art. 43 (on freedom of establishment) of the EC Treaty.

Briefly, the Court held that Art. 57-C of the CIRC was contrary to Arts. 6 (on fundamental rights), 43, 49, and 56 of the EC Treaty and that, considering the violation of EU law, it was not necessary to analyse other potential illegalities raised by the taxpayer (namely, the violation of Arts. 24(4) and (9) of the Portugal–Ireland income tax treaty). The tax corrections and assessments challenged by the taxpayer were held to be void, and the tax authorities did not present any further challenge to the Court's decision.

In fact, before the decision was rendered (and anticipating the result), the thin capitalization provisions were amended. Since 1 January 2006, these rules apply only to intercompany loans provided by non-EU associated enterprises[16] as indicated above. Therefore, the current thin capitalization provisions appear to comply with EU law because they no longer discriminate between intercompany loans provided by resident and non-resident associated enterprises.[17] The findings of the ECJ in the *Lankhorst-Hohorst* case seem to ascertain this. It also appears to be sustainable that even if the intra-group lender company is not a resident of a Member-State, the taxpayer can still rely on the fundamental freedom of establishment to oppose a tax assessment on the basis of the Portuguese thin capitalization rules, if the "special relationship" between them stems from the fact that both the lender and the Portuguese borrower have a common (direct or indirect) parent company resident in a Member State.[18]

6. Thin Capitalization Rules and Transfer Pricing

Under the thin capitalization provisions, a threshold general debt:equity ratio is 2:1 – currently one of the lowest ratios in Europe. Notably, the ratio itself was not reviewed as part of the 2006 amendments to the rule. Considering that under these rules, (1) a non-resident entity may with a small ownership stake (10%) in the Portuguese entity be deemed to be an associated enterprise by virtue of the extension of the "special relationship rule" and (2) the analysis of whether the 2:1 ratio is exceeded must be made at any time during the tax period, the thin capitalization provisions clearly represent a substantial burden for companies.

As mentioned above, Portugal is limited in its attempts to disallow deductions for interest payments (under Portuguese thin capitalization provisions) when it follows the recommendations of Arts. 9, 11 and 24 of the OECD Model Treaty. The OECD Model Treaty Commentary on Art. 24(4) specifically states that such a disallowance is permitted only if it is compatible with both Arts. 9 and 11(6) of the OECD Model Treaty.

As discussed in the Commentary to Art. 9, thin capitalization rules must comply with the arm's length principle. In other words, a factual and circumstantial test should determine whether the required legal ratio of 2:1 reflects the arm's length ratio of debt:equity in the relevant industry of the taxpayer (irrespective of the analysis of the transfer pricing issue of whether the interest rate on the relevant debt is arm's length). The fact that Portuguese thin capitalization provisions apply automatically once the fixed debt:equity ratio is exceeded renders its application to be independent of any finding as to the abusive nature of the intercompany loan. Thus, the Portuguese thin capitalization rules cannot properly rely on an anti-abuse justification, as it is impossible to identify the threshold at which debt financing becomes abusive.[19]

In the Portuguese court case discussed above, the Court rejected the argument of the tax authorities that the mere fact that the threshold debt:equity ratio was surpassed by the taxpayer, is sufficient justification for application of the thin capitalization rules, regardless of whether it was arm's length indebtedness within the taxpayer's industry or considering the taxpayer's business

13. The taxpayer also presented concluding evidence that the Portuguese subsidiary entered into to the intra-group loan in order to minimize its expenses and achieve savings on bank interest charges.

14. ECJ judgment of 12 December 2002, Fifth Chamber (C-324/00), *Lankhorst-Hohorst GmbH*, with the opinion of the Advocate-General J. Mischo delivered on 26 September 2002.

15. For an analysis of the implications of the ECJ's *Lankhorst-Hohorst GmbH* decision, see Linda Brosens, "Thin Capitalization Rules and EU law", 13 *EC Tax Review* 4 (2004), at 188.

16. The 25% ownership criterion was also replaced by reference to the concept of "special relationship", which merely requires a 10% ownership in the Portuguese associated enterprise (cf. Art. 58 CIRC).

17. For the issue of whether this solution would still result in discriminatory treatment of creditors resident in third countries and a possible violation of Art. 56 of the EC Treaty, see Brosens, note 15, at 196-197. The issue might be analysed by the ECJ in the pending case *Test Claimants in the Thin Cap Group Litigation*, C-524/04, where a preliminary ruling on the compatibility with UK thin capitalization rules with Art. 56 of the EC Treaty was also submitted. However, Advocate-General Geelhoed has dismissed such an enquiry on the basis that the eventual restriction on the free movement of capital is a "*purely 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 EC*" (Advocate-General Geelhoed, Opinion of 29 June 2006, *Test Claimants in the Thin Cap Group Litigation*, C-524/04, para. 35 and 36).

18. See Advocate-General Geelhoed, Opinion of 29 June 2006, *Test Claimants in the Thin Cap Group Litigation*, C-524/04, para. 95 and 98.

19. See Brosens, note 15, at 195.

conditions or strategy.[20] The Court noted that such an interpretation would violate the arm's length principle as enshrined in Portuguese tax law and thus held that the thin capitalization provisions, in that sense, are illegal.

The thin capitalization provisions allow the taxpayer to prove that the excess debt (i.e. over the threshold) is due to specific circumstances, as indicated above. Therefore, one might say that the Portuguese debt:equity ratio functions as a safe harbour.

Furthermore, intercompany loans are subject to documentation requirements under Portuguese transfer pricing rules.[21] Any transaction between associated enterprises must be adequately documented, and the transfer pricing methodology must be supported by contemporaneous documentation.[22]

Regarding the applicable interest rate, the tax authorities in their transfer pricing practice have seemed to accept the presentation of quotes from unrelated parties (e.g. banks) and the market interest rate as sufficient proof of compliance with the arm's length principle. However, compliance with the other documentation and transfer pricing rules is also required to substantiate the validity of such a controlled transaction. Therefore, taxpayers should be prepared to provide the tax authorities with the criteria used to determine the transfer price of the loan (i.e. the interest rate).[23] Careful attention should be given to factors such as the debtor's credit rating (taking into consideration that a specific determination for each associated enterprise of the group is required because the individual debtor's credit rating could be different to the group's overall credit rating); the loan's term of maturity; the purpose of the loan; the currency in which the loan is denominated; the security provided (analysing the impact of an implicit parent guarantee derived from the integration of the associated enterprise in the loan's terms); and the country and industry of the debtor associated enterprise.

7. Conclusion

The authors' understanding is that the definition of an adequate internal intercompany loan transfer pricing policy for the group will reduce the risks of challenge by the Portuguese tax authorities with regard to loans between associated enterprises. In addition, special attention should be given to the details of such arrangements.

20. See also Fabio Aramini, "Thin Capitalization: Issues of Compatibility with EC Law and the OECD Model Treaty", 6 *Derivatives and Financial Instruments* 3 (2004), at 127.
21. *Maxime*, Art. 58.º CIRC and Decree 1446-C/2001 of 21 December 2000. Portuguese transfer pricing rules are in line with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
22. Currently, interest related to EU intercompany loans still attract withholding tax (10% until 1 July 2009 and 5% from 1 July 2009 to 1 July 2013), based on Art. 6.06 of Council Directive 2003/49/EC of 3 June 2003.
23. See also Michel E.P. van der Breggen, "Intercompany Loans: Observations from a Transfer Pricing Perspective", 13 *International Transfer Pricing Journal* 6 (2006), at 295.