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# Treaty Overrides Administrative Rule, Tax Court Says

*by Francisco de Sousa da Câmara*

The Lisbon Tax Court has issued a decision clarifying that payments by a Portuguese resident to a service provider resident in a state that has signed an income tax treaty with Portugal may be made in gross (without the imposition of the usual 15 percent withholding tax), waiving the usual administrative formalities, if the Portuguese taxpayer is able to prove at a later stage that the payee is a resident in the state with which Portugal signed the treaty.

## The Facts

The case involved Portugal's main energy company, *Energias de Portugal*, *S.A.* (EDP), which paid fees to several companies resident in the United States, Brazil, and the United Kingdom for services rendered in 1999 and 2000. All payments were made without withholding tax.

International services became taxable in Portugal in 1998 in accordance with Decree-Law 25/98 of February 10, 1998. From that moment on, all payments to nonresident entities for services performed or used in Portugal became subject to tax, and the payer was required to withhold 15 percent on those payments as individual income tax (IRS) or corporate income tax (IRC).

However, in principle, fees paid for services performed by entities resident in countries that have entered into a tax treaty with Portugal are not taxable at source. In fact, Portuguese tax treaties, which are based on the OECD model, follow the generally accepted principle that a company will be taxed only in its state of residence, except when it carries on business in another state (the source state) through a permanent establishment located there.

However, Portuguese tax authorities took the position that Portuguese payers must withhold tax at source (at the domestic rate of 15 percent) if they do not receive a certificate of residence issued by the tax authorities of the payee's state of residence before the payment takes place.

Tax authorities also justified an additional tax assessment (15 percent plus compensatory interest) based on the argument that entities that benefit from a corporate income tax exemption must prove their eligibility for the exemption to the payer of the income before the payment; otherwise, the payment should be subject to withholding tax.

## Legal Arguments and Decision

In its March 19 decision, the tax court considered whether EDP was required to withhold the 15 percent corporate income tax at source in accordance with the legal provisions applicable to payments of fees to nonresident corporate bodies, although none of the nonresident recipients (resident in the United States, Brazil, and the United Kingdom) completed, certified, and sent their certificates of residence to the Portuguese payer before the payment occurred.

The court considered the following facts:

- income tax treaties, as international conventions, prevail over Portuguese domestic legislation (article 8(2) of the Portuguese Constitution);
- the term "profits" referred to in article 7 of the treaties Portugal signed with Brazil, the United States, and the United Kingdom includes fees received by a company for consulting services rendered to the payer, and establishes that income should be exclusively subject to tax in the state where the payee has its residence;
- according to the proof already presented (the certificates of residence were presented in

court), all the payees are companies effectively resident in countries that have signed a tax treaty with Portugal;

- the tax authorities did not accept the presentation of certificates of residence after payment as sufficient to prevent the additional tax assessments;
- the administrative guideline that requires the presentation of certificates of residence before payments abroad to avoid withholding tax does not bind taxpayers or the courts;
- Portuguese domestic law prescribed specific procedures for the application of the tax treaties only at the end of 2002 (Law 32-B/2002 of December 30, 2002), at which time forms had to be completed, certified, and sent to the payer for the payee to benefit from the treaty provisions and for the payer to be effectively released from the withholding obligation; and
- all payments were made before Portugal's new income tax law entered into force (on January 1, 2003); therefore, any proof should be sufficient to evidence before the payer (and later, before the tax authorities) that the payees were resident in Brazil, the United States, and the United Kingdom, respectively.

On the basis of those facts and considering the documents included in the judicial file, the tax court ruled that the additional tax assessment was unfounded and declared it null and void. The compensatory interest assessed by the tax authorities also was rendered null and void.

## Current Domestic Law

The corporate income tax law currently requires that income tax withholding can be reduced or avoided only if the nonresident recipient of income that intends to benefit from the application of a tax treaty or other international and domestic tax regulations proves to the payer, before payment, that:

- the requirements to benefit from the treaty or other legal instrument have been met (proof in the presentation of a form approved by the Portuguese finance minister and certified by the payee's tax authorities); and
- the fulfillment of requirements to benefit from a reduced treaty rate of withholding tax should also be evidenced through a form that verifies that the payee is the beneficial owner of the income.

If the payer makes a gross payment abroad without having complied with those rules, the payer becomes primarily responsible for any tax not withheld and the corresponding compensatory interest.

Although a reduction or exemption of tax at source is more beneficial and straightforward for the nonresident recipients of income (which then do not need to claim a refund), it is riskier for the payer, considering its new legal responsibility. If payers don't have a copy of the standard form certified by the foreign tax authorities attesting to the recipient's residence, another tax and compensatory interest assessment will follow.

## Final Remarks

In the event of such an assessment, Portuguese law allows taxpayers to request a tax refund only for excessive withholding. However, the request must be made within two years after the taxable event, and the tax authorities may make additional assessments until the end of the fourth year after the taxable event.

This rule is contrary to any tax treaty in that it prevents the correct application of the treaty rules. It is also in violation of the Portuguese Constitution, as it is disproportionate and is not necessary to achieve its goal (the correct application of a treaty and the prevention of access to treaty benefits for parties that are not resident in a treaty-partner state).

Also, some countries do not officially recognize the forms approved by the finance minister. Taxpayers are confronted with a rule that impairs the applicability of Portugal's treaties and prevents them from establishing proof of residence and their role as beneficiary owners by any other means.

It isn't surprising that there are many cases before the courts contesting the validity of the administrative rule and arguing that it violates Portugal's tax treaties and the Portuguese Constitution.◆

♦ *Francisco de Sousa da Câmara, partner, Morais Leitão, Galvão Teles, Soares da Silva & Associados R.L., Lisbon*