CONFEDERATION FISCALE EUROPEENNE

Opinion Statement ECJ-TF 2/2016

on the decision of the Court of Justice of the EU of 13 July 2016 in Case C-18/15, Brisal and KBC Finance Ireland, on the admissibility of gross withholding taxation of interest

Prepared by the CFE ECJ Task Force

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The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.
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We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Mary Dineen, CFE Fiscal Officer, at brusselsoffice@cfe-eutax.org.

Introduction

This is an Opinion Statement prepared by the CFE ECJ Task Force on Case C-18/15, in which the 5th Chamber of the Court of Justice of the European Union (ECJ) delivered its judgment on 13 July 2016, following the opinion of Advocate General Juliane Kokott of 17 March 2016[1]. It is a response to a request from the Supremo Tribunal Administrativo (Supreme Administrative Court, Portugal) for a preliminary ruling, under Article 267 TFEU.

The judgment is a further interpretation of the permissibility of withholding taxation within the EU. In relation to interest, the Court holds that non-resident taxpayers may be subject to withholding taxes, even if comparable residents pursuing the same activity are not. Nonetheless, those non-residents may not be taxed on gross income when comparable residents are taxed on net profits. Member States have to grant those non-residents the same right to deduct expenses directly connected with their business activity.

I. Background and Issues

1. Brisal – Auto Estradas do Litoral SA (henceforth Brisal) is a Portuguese company. In 2004, Brisal borrowed funds from a syndicate of banks. In 2005, KBC Finance Ireland (henceforth KBC) joined the syndicate. Between 2005 and 2007, Brisal paid interest to KBC. Following domestic and tax treaty rules, Brisal withheld 15% of the gross amount of interest (as Portuguese corporate income tax), and remitted it to the Portuguese tax authorities.

2. According to Portuguese domestic law, interest received by non-resident financial institutions is subject to a 20% final withholding tax on the gross amount. This rate may be reduced to 15% or 10%, depending on the applicable tax treaty. Interest received by resident financial institutions is not subject to any withholding but they are subject to corporate tax of 25% of their net profits.

3. Against this background, in 2007, Brisal and KBC made an administrative appeal to the tax authorities claiming infringement of the free movement of services, which was dismissed. They appealed to the Portuguese court: this was also dismissed. They then appealed to the Supremo Tribunal Administrativo, that decided to refer the issue to the ECJ. In essence the referring Court asked whether the freedom to provide services precludes a national regime which
   - applied withholding tax only to payment of interest to non-residents;
   - taxed non-residents on their gross profits whereas comparable residents would be taxed only on a net basis;
   - and, if so, for which expenses a deduction should be allowed, specifically whether expenses calculated on a notional basis could be deducted.

4. In her opinion, Advocate General Kokott concluded that the national legislation infringed the freedom to provide services. The infringement, however, resulted not from applying withholding tax solely to payments to non-residents but rather from the use of different tax bases and calculation methods, in particular the prohibition on non-residents deducting actual expenses directly connected with the activity generating the income being taxed.

[1] Opinion of Advocate-General Kokott : link

II. The Judgment of the Court

5. **Applicable Freedom**
The Court's Fifth Chamber starts by noting that the facts took place before 1 December 2009 and that, accordingly, the case as to the freedom to provide services would be judged by reference to Article 49 EC (and not by reference to Article 56 TFEU).

6. **Use of different methods of taxation for residents and non-residents**
The first issue was to determine whether applying withholding tax only for non-resident financial institutions was permissible. Referring to its previous case law in Scorpio and X, the Court confirmed that although such a difference in treatment would amount to a restriction, it would be justified by the need to ensure effective collection of tax.

7. **Calculation of the Tax Base – Net versus Gross**
The second (and main) issue examined by the Court was the permissibility of a different tax base for non-resident financial institutions deriving interest from Portugal. The Court considered this a restriction on the free provision of services and rejected all arguments from the Portuguese government, both as to comparability and as to justification and proportionality.

a. **Comparability.** By reference to its previous case law in Gerritse, Conijn and Centro Equestre da Lezíria Grande, the Court reiterated that resident and non-resident service providers are in a comparable situation in relation to the deduction of business expenses directly connected to the activity pursued. It explicitly rejected the Portuguese government's claim that financial services should be distinguished from other services based on a perceived impossibility of establishing "any characteristic link between costs incurred and interest income received". The Court pointed out that the EC Treaty does not support such a distinction and that services provided by financial institutions cannot, "as a matter of principle, be treated differently from the provision of services in other areas of activity."

b. **Justification and Proportionality**. The Court also rejected all the justifications presented by the Portuguese government, i.e., (1) the availability of other advantages; (2) the need to preserve a balanced allocation of taxing powers; (3) the need to fight against tax evasion and prevent double deduction of business expenses; and (4) the need to ensure the effective collection of tax.

   - First, the advantage granted to non-resident financial institutions, i.e., the fact that a more favourable tax rate is applied to non-resident financial institutions (20% withholding tax) than the one which is applied to resident financial institutions (25% corporate income tax), was merely potential and, as such, could not justify the restriction. Relying on Dijkman and Dijkman-Lavaleije and X, the Court reiterated that "unfavourable tax treatment contrary to a fundamental freedom cannot be regarded as compatible with EU law because of the potential existence of other advantages", specifically noting that the restriction at issue "cannot be justified by the fact that non-resident financial institutions are subject to a tax rate which is lower than the rate for resident financial institutions".

   - Second, the Court noted that, while the allocation of taxation powers between Member States remains for Member States to decide, "there is in the present case nothing which can explain

in what way the allocation of taxation powers require that non-resident financial institutions, with regard to the deduction of business expenses directly related to their taxable income in that Member State, must be treated less favourably than resident financial institutions."

- Third, the Court rejected a justification based on the prevention of double deduction of business expenses, which may be linked to the fight against tax evasion, as Portugal had failed to demonstrate why Council Directive 77/799/EEC (in force at the time of the facts) could not be used to prevent the potential risk of double deduction of the business expenses in question.

- Finally, while to ensure the effective collection of tax may constitute a valid justification in light of Scorpio and X, the "restriction must still be applied in such a way as to ensure achievement of the aim pursued and not go beyond what is necessary for that purpose". The Court did not, however, find such a necessity to apply a different method to non-residents and hence concluded that the proportionality test was not met. Three issues were decisive:

    - First, the Court rejected the argument that giving taxpayers with limited liability the opportunity to deduct business expenses directly related to the services provided in the that territory would give rise to an administrative burden for the national tax authorities, because that argument also applies, mutatis mutandis, in the case of taxpayers with unlimited liability.
    - Second, an additional burden on the recipient of the service would only exist in a system which provides that that deduction must be made before withholding tax is applied; conversely, such burden is avoided "in the case where the service provider is authorised to claim its right to deduction directly from the authorities once IRC has been levied" (i.e., receive a reimbursement of a fraction of the tax withheld at source). The Court hence hints at what might be considered a balanced system: a simple withholding procedure (in the hands of the resident service receiver) followed by a reimbursement procedure (at the initiative of the non-resident service provider).
    - In such a system, third, it is for the service provider to decide whether it is appropriate to invest resources in drawing up and translating documents intended to demonstrate the genuineness and the actual amount of the business expenses which it seeks to deduct.

8. **Expenses to be deducted**

The third (and last) issue examined by the Court was "how to determine the business expenses directly related to interest income arising from a financial loan agreement".

a. In analysing this issue, the Court further explained the notion of business expenses directly linked with the interest income in question, starting from the point of equal treatment: for the Court, any deductions available to residents should also be granted to non-residents carrying out the same activities. The Court also restated its own case law "that business expenses directly related to the income received in the Member State in which the activity is pursued must be understood as expenses occasioned by the activity in question, and therefore necessary for pursuing that activity".

b. The Court then considered loans specifically, and clarified which expenses would meet that criterion. These would be (1) specific expenses ("such as travel and accommodation expenses, legal or tax advice" insofar as they are also granted to residents), and (2) apportionable general expenses or overheads (including "the fraction of the general expenses of the financial institution which may be regarded as necessary for the granting of a particular loan").

c. The Court recognizes that it may be more difficult with business expenses of a non-resident to show genuineness, and the link with the relevant business activity. Nonetheless, as these can be accepted for residents, they cannot be (a priori) denied for non-residents. By reference to the previous decisions in Persche and in Kohll and Kohll-Schlesser, the Court stressed that tax authorities are free to require sufficient evidence to prove that the expenses are directly connected with the activity in question.

d. In computing business expenses, only real costs can be considered (provided that the system applicable for residents is also limited to real costs). The Court explicitly refused the deduction of costs calculated on a notional basis, as claimed by Brisal and KBC Ireland in the main proceedings, i.e. calculating the overheads by reference to indexes such as those provided by Euribor or Libor. Besides the fact that domestic lenders cannot calculate their deductions on that basis, the Court pointed out that KBC Ireland did not fund this specific loan solely with funds received from its parent company or other banks but also with funds obtained from its clients. The decision on which specific costs should be considered to have a direct link with the activity, based on domestic law, was left to the referring Court.

e. The court further stated that the administrative burden "may therefore be avoided in the case where the service provider is authorised to claim its right to deduction directly from the authorities once IRC has been levied. In such a case, the right to deduct will take the form of a reimbursement of a fraction of the tax withheld at source".

9. **Conclusion**

The Court concluded by summarizing the answers to the three questions brought by the Portuguese Supreme Administrative Court, holding:

"Therefore, in light of all the foregoing considerations, the answer to the questions referred for a preliminary ruling is that:

- *– Article 49 EC does not preclude national legislation under which a procedure for withholding tax at source is applied to the income of financial institutions that are not resident in the Member State in which the services are provided, whereas the income received by financial institutions that are resident in that Member State is not subject to such withholding tax, provided that the application of the withholding tax to the non-resident financial institutions is justified by an overriding reason in the general interest and does not go beyond what is necessary to attain the objective pursued;*
- *– Article 49 EC precludes national legislation, such as that at issue in the main proceedings, which, as a general rule, taxes non-resident financial institutions on the interest income received within the Member State concerned without giving them the opportunity to deduct business expenses directly related to the activity in question, whereas such an opportunity is given to resident financial institutions;*

– it is for the national court to assess, on the basis of its national law, which business expenses may be regarded as being directly related to the activity in question."

III. Comments

10. The present case is one step further in a sequence of cases addressing the compatibility of withholding taxes with the fundamental freedoms, such as Scorpio, Truck Center, Commission vs Portugal, X, Hirvonen, and Miljoen. When Truck Center was decided, some interpreted it as carte blanche for Member States to apply different systems of tax collection for residents and non-residents. However, with Miljoen, Hirvonen and Brisal, it becomes clear that even if a different method of tax collection for residents and non-residents may be justified, that does not automatically permit differences in the tax base or other features.

11 Commission v Portugal, was an infringement procedure relating to the same legislation as Brisal. The Court considered that the Commission had failed to show how the withholding method would lead to a more disadvantageous position for non-resident financial institutions (as it merely raised hypothetical examples instead of relying on actual data). In Brisal, as there was a specific taxpayer, it could in principle show a real difference in treatment. Curiously, neither the AG Opinion, nor the Court's decision explicitly mentioned the calculations that evidenced that restriction. Therefore, one may wonder why the Court did not reach the same conclusion as in Commission vs Portugal. Both cases concerned one and the same set of rules and we believe that the different decision is only due to the burden of proof imposed on the European Commission in an infringement procedure.

12. Also, in Brisal the Court adopts a more generous approach towards deductibility than, e.g., in Miljoen. For the Court, the key feature that allows a cost to be a deductible expense is its connection with the taxable activity. In Miljoen, regarding dividends, the financing costs needed for the acquisition of the shareholding were not considered deductible expenses as they concerned only the ownership per se. According to AG Jääskinen in that case, an expense will be considered to have a direct link if it is "necessary in order to carry out the activity which gives rise to those expenses". The shareholding is apparently not necessary to carry out the activity that produces dividends. In Brisal, for interest the situation is different, there will be a direct link in case of "financing costs which are necessary for carrying out an activity", and the Court allows directly related expenses and overheads and considers that both are necessary for the taxable activity, which is granting a loan. It is difficult to understand why the costs of holding shares should not be deductible (Miljoen) when the costs of holding loans are (Brisal). It is also curious that the Court did not even refer to Miljoen even though AG Kokott discussed the relationship between the cases at length.

13. The direct impact of this decision should not be overestimated. Most Member States have already abolished their withholding systems for interest or grant generous exemptions. Therefore, only a few will have to revisit their interest withholding tax regimes. Nonetheless, this decision does have a deterrent effect for the future: Member States will now be aware of the severe limitations they face when introducing such a system for the taxation of non-residents on interest.

14. The indirect impact of the case may be much wider. We will consider this from a taxpayer and an income perspective, taking into account the applicable freedom. In our opinion, the logic of this ruling is applicable:

a. not only to financial institutions but to any entity that receives interest as part of its business activities (and that, therefore, may be in a comparable position with residents being taxed on a net basis).
b. to royalties: in both cases, passive income is derived from the exercise of a business activity that requires direct costs and overheads.

One may wonder what the indirect impact of Brisal is on dividends. The AG clearly distinguished Miljoen and Brisal, saying only in case of interest the costs related with acquiring the loan would be deductible, as they relate to income from economic activity (whereas dividends are to be viewed as the mere consequence of holding shares). The Court followed the AG Opinion without a clear distinction between both types of income. It remains to be seen whether in future decisions the Court will continue to distinguish between dividends and interest or whether, following Brisal's line of reasoning, it will consider that costs related to the acquisition of the shareholding should also be considered deductible costs.

15. Both the decision and the AG opinion are based on the freedom to provide services only. There are reasons to think the correct freedom might be freedom to move capital. In an intra-EU situation it is generally not material under which freedom a domestic measure is scrutinised. This may explain why there was no discussion of the correct freedom. In a third country scenario, it would be critical whether free movement of capital applied. Brisal should not be taken to determine that it would not.

16. In conclusion, Member States wishing to maintain their withholding tax systems for non-residents without a permanent establishment have to allow deduction of directly connected business expenses which residents can deduct in computing their taxable profits.

17. It remains, however, doubtful whether Member States could implement a straightforward refund procedure, at a later stage and in the hands of the non-resident service provider without also giving him the option to claim such a deduction during the withholding procedure. In Scorpio the Court held that the taxpayer must be given the possibility to deduct business expenses which are directly linked to activities in the source state as part of the withholding procedure. However, in Brisal a paragraph of the judgment could be interpreted as saying that the fundamental freedoms do not oblige a Member State to allow deduction of business expenses when calculating the withholding as long as the Member State allows the taxpayer to give effect to his right to deduction during a subsequent refund procedure. While it is true that the verification of the business expenses can be burdensome for the recipient of the services a subsequent tax assessment will be all the more burdensome for the service provider as he is usually neither familiar with the language nor with the tax system of the source state. We strongly urge the ECJ to follow its reasoning in the Scorpio case and require the Member States to grant the service provider the choice between an immediate deduction of business expenses during the withholding procedure or a subsequent refund procedure.

18. We can also predict disadvantages in terms of the administrative burdens on taxpayers. As stated in Scorpio, "the obligation, even where the non-resident provider of services has informed his payment debtor of the amount of his business expenses directly linked to his activity, to commence a procedure for the subsequent refund of those expenses is liable to impede the provision of services. In that commencing such a procedure involves additional administrative and economic burdens, and to the extent that the procedure is inevitably necessary for the provider of services, the tax legislation in

question constitutes an obstacle to the freedom to provide services". The same concern regarding the burden of proof was expressed in this case.

19. In terms of the interaction with tax treaties, allowing deduction of business expenses does not convert this interest income into business profits (Art. 7 of the OECD MC). The interest income will still fall under the definition in Art. 11(2) OECD MC, and Art. 7(4) grants precedence to Art. 11, unless there is a PE in the source State (Art. 11(4) of the OECD MC9).

IV. The Statement

20. The Confédération Fiscale Européenne welcomes the clarification made by the Court regarding the operation of withholding tax on interest paid to non-residents. It is now unambiguous that, despite authorising the application of such method (if justified and proportional), the Court considers that resident and non-resident service providers are comparable and that deduction of expenses granted to residents should be made available to non-residents.

21. The Confédération Fiscale Européenne stresses that Member States wishing to keep (or to introduce) withholding tax systems need to take into account not only the substantive tax result of allowing a deduction but also ensuring that non-residents are not discriminated against with regard to proving the expenses. The CFE also welcomes that the taxpayer is given the option of whether or not to use such a system because it allows it to take into account his compliance costs when deciding whether or not to do so.

22. The Confédération Fiscale Européenne recommends that advisors within its member organisations revisit the situation with their clients, and advise them on whether to file protective claims not only in cases falling directly under the scope of the decision but in relation to all withholding taxes, as described in this Opinion Statement, where the same rationale seems applicable.