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TAX HARMONISATION IN THE EU

Difficulties and Recent Developments

1. Unlike the case of indirect taxation (e.g. VAT) for which the European Community Treaty (EC Treaty) includes specific harmonisation provisions, the Treaty makes no specific provision for direct taxation (e.g. income tax).

It was realised very early on, however, that implementing the ancillary principles of non-discrimination and the fundamental freedoms set out in the EC Treaty (free movement of goods, workers, capital and services) would require some effort at harmonisation in this area by the Community institutions and the suppression of a certain degree of inertia and disinterest on the part of the Member States in bringing their domestic law into line with the above-mentioned principles: States which may view the harmonisation of direct taxation as the loss of yet another budget policy and deficit-fighting instrument.

A fundamental role has been played in this regard by the European Commission, both through carrying out studies and formulating proposals and recommendations for the Member States as well as through presenting proposals for legislative amendments to the European Council, and by the European Court of Justice (ECJ) which, by applying its decisions in particular cases in a reasonably uniform manner, has allowed the development of consistent case law on this issue.

2. The examples we could cite of the roles played by the abovementioned institutions in recent years are many and varied.

In relation to the role of the Commission (but in no way detracting from the other extremely important studies, reports and recommendations which were initiated by this particular body) we must highlight, owing to their significance, the proposals which led to the approval by the Council of legislative instruments as important as the Common System of Taxation on mergers, divisions, transfers of assets and exchanges of shares, the Parent-Subsidiary Directive (/90/435/EC), the Arbitration Convention (90/436/EC) and a common system of taxation applicable to the payment of interest and royalties (2003/49/EC), as well as by the preparatory work done by the working group on a common consolidated corporate tax base with a view to formulating a legislative proposal, the conclusions of which have been recently divulged in a Commission Communication. (Common Consolidated Corporate Tax Base – CCCTB).

In the case of the ECJ, we can point out the examples, from among many others, of the most recent decisions handed down in the cases of Commerzbank (C-2004/314/37), Royal Bank of Scotland (C-2006/074/44), Lankhorst-Hohorost GmbH (C-2003/031/03) and Marks & Spencer (C-2006/036/09), all inclining to the view that discriminatory treatment based on the State of residence or, in the latter case, on the State where the loss was generated, was inadmissible.

Since our national law also harbours discriminatory solutions from the perspective of the tax treatment of non-residents, it comes as no surprise that Portugal has already been targeted by the Commission and the ECJ in this harmonisation task.

3. In 2005, the Commission brought an action against Portugal on this ground because of the provision which only allows income tax exemption on capital gains made on the disposition of a permanent personal residence when the proceeds of the sale are reinvested in a permanent personal residence located within Portuguese territory.

This action would later lead to the 2007 State Budget Law (Law 53-A/2006 of 29 December) conferring legislative power on the government to review the above-mentioned taxation exemption with a view to also covering the reinvestment when the property is situated in another European Union Member State or in the European Economic Area (EEA).

4. In the same year, the European Union declared war on yet another front against the Portuguese State in respect of the taxation of interest paid to non-resident entities without a permanent establishment in Portugal, deeming that the 20% withholding tax applicable to the gross interest paid by Portuguese residents who have contracted a loan from non-resident lenders was discriminatory. Conversely, resident financial institutions only pay tax on interest received net of any charges paid as necessary to providing the lent capital.

The Commission was of the opinion that the tax on gross interest constituted discriminatory treatment of foreign financial institutions for whom the possibility of granting cross-border loans was thus restricted, and at the same time made it difficult (or impossible) for Portuguese citizens to take out loans (mortgage loans or otherwise) with such institutions.

5. In 2006, the refusal of the Portuguese State to amend its tax law on the payment of interest abroad would actually lead the Commission to commence proceedings in the European Court of Justice on the grounds that Portugal had not implemented its Opinion within the prescribed period (Article 226(2) of the EC Treaty).

In the same year, the Commission formally requested Portugal to repeal a provision of the Tax Benefit Statute which provided for a waiver of tax on capital gains made by wholly-owned State companies or by companies in a control relationship with such companies, in the context of privatisation or restructuring operations, as it took the view that this tax benefit would be incompatible with the prohibition on state aid set out in the EC Treaty.

This recommendation would be taken on board by the Portuguese State, which repealed the offending provision from the Tax Benefits Statute (See Law 53-A/2006 of 29 December which enacted the 2007 State Budget Law).

6. In 2007, the European Commission asked the Portuguese State, by means of a reasoned opinion, to put an end to the different taxation regime applicable to non-resident service providers in respect of income received in Portuguese territory.

As the Commission saw it, such a regime could constitute a dissuasive element for services providers established abroad who intended to carry on their business in Portugal, and could deter Portuguese customers from acquiring services from such suppliers.

7. Still more recently, the European Commission, in one of its Communications, took the view that the tax amnesty for undeclared funds held abroad (RERT), approved by the Parliament in 2005 (Law 39-A/2005 of 29 July), by implying a reduced tax rate for funds consisting of Portuguese government bonds, as well as for any other funds reinvested in Portuguese government bonds, constitutes a restriction (due to discriminatory treatment) to the freedom of movement of capital enshrined in the EC Treaty.

More specifically, the Commission stated that the RERT established a preferential tax rate for regularisation in relation to investment in Portuguese government bonds at 2.5% as against the 5% applicable to any other assets.

In its view, investments related to a Member State which was not that of the resident Member State must be taxed identically to those related to the Member State of residence (notwithstanding the fact that they fall within the scope of tax amnesties). In this respect, as the European Commission concluded, anyone who intended to take advantage of the amnesty was thus dissuaded from regularising its assets in any way other than in Portuguese government bonds.

8. It is likely that the national tax treatment for dividends and distributed profits in particular will generate still more conflict in the future.

In January 2007, the Commission announced that it would take action against several EU Member States including Portugal, based on the alleged discriminatory treatment of dividends paid to entities domiciled in other Member States and in the three EFTA countries parties to the EEA agreement.

More recently in May 2007, the Commission raised a potential tax discrimination problem with several Member States, including Portugal, which would affect the payment of interest and dividends to foreign pension funds. The Portuguese government has already been asked to provide information in this respect.

Although we are as yet unaware of any decisions in these procedures, given the strict interpretation of the principles of free movement of capital and freedom of establishment which the ECJ has upheld throughout the years, the outcome is easy to predict.

9. The rule on the elimination of economic double taxation of distributed profits also raises some compatibility issues with the provisions of the EC Treaty.

Initially, the IRC Code (Corporation Tax Code) harboured discriminatory treatment (Article 46 formerly Article 45), by allowing the elimination, by 50%, of double taxation levied on dividends distributed by resident companies, regardless of whether the requirements related to the percentage and duration of the holding were met, but made no such allowance for dividends distributed by non-resident companies.

In the 2007 State Budget Law (enacted by Law 53-A/2006 of 29 December), the legislative assembly, in order to forestall potential claims, whether administrative or judicial, sought to remedy this situation by extending the above-mentioned facility to profits distributed by entities envisaged by the Parent-Subsidiary Directive (Directive 90/435/EEC, of 23 July).

10. On a different note, it would appear that the solution (set out in Article 46(11) of the Code) of allowing the elimination of double taxation by only 50% when the income derives from profits which have not effectively been taxed, apart from being likely to offend against the principle of freedom of establishment, is still in breach of the Parent-Subsidiary Directive.

11. The examples we have given lead to the conclusion that although the harmonisation of direct taxation would still appear to be a long way off – despite the Commission's aim, according to the above-mentioned Communication and in the wake of the working group report on a common consolidated corporate tax base, to present a legislative proposal on this matter in 2008 - there appears to be no alternative for national legislative assemblies but to eliminate gradually from their own legislation any provisions which are contradictory to the principles of the EC Treaty, particularly in relation to non-discrimination.

Until this happens, the Commission and the ECJ, impelled by the taxpayers, will certainly remain focused on the mission they have taken upon themselves, and of which the Portuguese legislature must also take notice. There appears to be no other alternative given the scant attention that the European Court of Justice affords to the preservation of tax sovereignty in direct taxation matters which the Member States, or so it would appear, intended to reserve to themselves in the EC Treaty.

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