TAX INFORMATION

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Advising with Value
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EUROPEAN UNION FREEDOMS, DISCRIMINATION AND TAXATION IN PORTUGAL

1. The European Union Treaty enshrines economic freedoms – freedom of movement of workers and capital, as well as freedom to settle and provide services – protected by the prohibition of discrimination that, over the years, have shown great potential to call into question many tax provisions of the Member States in the area of direct taxation. The no less important rules of the European Union Treaty in relation to "state aid" have also had their share of responsibility for imposing limitations on the design of the income tax systems of Member States, but these will only be mentioned in passing here.

The European Commission and the Court of Justice of the European Union (CJEU as it is now know following the Treaty of Lisbon, formerly the Court of Justice of European Communities) have been the agents in gauging the compatibility of the rules on taxation of income with the rules of the EU Treaty in the field of direct taxation.

2. The purpose of this tax information is to provide an up-to-date reference in relation to the set of initiatives and decisions of EU agencies on procedures for assessing the compatibility of the Portuguese income tax system with the rules of the EU Treaty on so-called EU (economic) freedoms.

3. As is the case in the legislation of other Member States, Portuguese legislation contains some provisions that are discriminatory or restrictive in respect of the exercise of EU freedoms in the case of the tax treatment of non-residents, or of residents who wish to exercise these freedoms in EU territory. In light of the interpretations of these concepts adopted by the EU agencies, it is not surprising that Portugal has already been the target of actions that aim to extinguish or modify the provisions of the Portuguese legislation in question.

I) Conflicts that started in 2005

4. As far back as 2005, the Commission began proceedings against Portugal because of the rule that only exempts gains realised from the sale of a principal private dwelling from personal income tax (IRS) if the proceeds of sale are reinvested in

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"Portuguese Law Firm of the Year"
Chambers Europe Excellence 2009, IFLR Awards 2006 & Who's Who legal Awards 2006, 2008. 2009

"Corporate Law Firm of the Year - Southern Europe"
ACQ Finance Magazine, 2009

"Best Portuguese Law Firm for Client Service"
Clients Choice Award - International Law Office, 2008, 2010

"Best Portuguese Tax Firm of the Year"
International Tax Review - Tax Awards 2006, 2008

Mind Leaders Awards TM
Human Resources Suppliers 2007

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another principal private dwelling located in Portuguese territory.

These proceedings would lead to the State Budget Law for 2007 (Law no. 53-A/2006, of December 29) establishing a legislative authorisation, which would be used during 2007 (see Decree-Law No. 361/2007, of November 2, which amends the Income Tax Code for Individuals), for the Government to revise the tax-exemption scheme so as to allow re-investment when the property is situated in another Member State of the European Union or European Economic Area (EEA).

5. Also in 2005, the European Commission opened another battlefront against the Portuguese State in relation to tax on interest paid to foreign organisations with no permanent establishment in Portuguese territory, after finding the 20% withholding rate applied to gross interest paid by Portuguese resident borrowers to non-resident lenders in the country to be discriminatory.

In fact, and in contrast to this, Portuguese financial institutions only pay tax on net interest income of expenses incurred in the provision of loan capital.

According to the Commission, this tax on the gross interest constitutes discrimination against foreign financial institutions that see their ability to engage in cross-border lending restricted and, at the same time, this complicates (or prevents) the ability of Portuguese citizens to take out loans, whether mortgages or not, with them.

In 2006, the Portuguese State's refusal to change its tax legislation in respect of interest payments abroad would lead the Commission to announce the issue of proceedings in the CJEU, based on the fact that Portugal had not, within the due time limit, complied with its Statement (Paragraph 2 of Article 226. EU Treaty). These proceedings were finally issued in March 2008.

A recent CJEU ruling on the tax legislation of the Belgian State on interest ("SPF Finances", Case C-282/07) allows Portugal to discern significant chances of success in this litigation relating to interest in the current context, because in that case it was found that "the different means of collecting the tax [by withholding in the case of non-nationals, or by submitting a declaration in the case of nationals] are the corollary of the domestic and foreign [interest] receiving companies being subject to different taxation [in that] (...) the different means of taxation are the reflection of different [not comparable] situations that these companies find themselves in regarding the collection of tax".

II) Conflicts that started in 2006

6. Moving on to the points of contention that first arose in 2006, it should first be noted that in this year the Commission formally asked the Portuguese state to repeal the rule in the Statute of Tax Benefits that established an exemption from taxation on capital gains made by wholly publicly owned companies, or companies with which they share a controlling relationship, in the context of privatisation or restructuring operations, understanding that this tax benefit would be incompatible with the prohibition on state aid established in the EU Treaty.

The main reason cited by the Commission was not the existence of discriminatory treatment, in contrast with what would happen in 2008 with the exemption scheme that benefitted prizes for games managed by the charitable organisation *Santa Casa da Misericórdia de Lisboa*.

This recommendation would come to be accepted by the Portuguese State, which repealed the said provision of the Statute of Tax Benefits (see Law No. 53-A/2006 of December 29, which approved the State Budget for 2007).

7. Also in 2006, the Commission asked several Member States, including Portugal, to discontinue the discriminatory treatment for dividends paid to non-residents. Also, in the following year, the Commission announced that it would start legal action against several EU Member States, including Portugal, based on these allegedly discriminatory practices applied to dividends paid to agencies based in other Member States and three EFTA countries party to the EEA Agreement.

Portugal would only react in the State Budget Law of 2008 by providing for the exemption from company tax (IRC) on profits which a company based in Portuguese territory meeting the conditions of the Parent-Subsidiary Directive (Directive 90/435/EEU of July 23) makes available to an entity based in another EU Member State or a permanent establishment in another Member State, of an entity based in a Member State of the EU, provided they meet similar requirements to those required in domestic situations.

III) Conflicts that started in 2007

8. In 2007, the European Commission requested the Portuguese State, through a reasoned opinion, to put an end to the differential taxation scheme applicable to non-resident service providers with regard to income obtained in Portuguese territory.

This new battlefront was predictable following the start of the other battle relating to interest.

The main reason cited by the Commission was not the existence of discriminatory treatment, in contrast with what would happen in 2008 with the exemption scheme that benefitted prizes for games managed by the charitable organisation *Santa Casa da Misericórdia de Lisboa*.

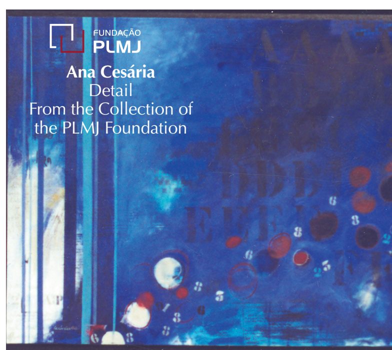
According to the Commission, this scheme could become a disincentive for service providers established in other countries and wishing to pursue their activity in Portugal, and might dissuade Portuguese clients from acquiring services from these suppliers.

And in 2008, the Commission once again confronted Portugal with this broader topic of taxation in Portugal for services provided by non-residents, in a statement which reiterated the decision to begin legal proceedings against Portugal in the CJEU for discriminatory tax treatment of non-Portuguese service providers.

The Portuguese state only came to heed the recommendations of the Commission in the State Budget Law for 2009, amending its legislation so as to allow a national of another member state of the EU or EEA to apply for a refund of tax deducted at source on income from providing services for the part that exceeds the tax that would be paid by someone resident in Portugal.

But Portugal went even further in this field, in anticipation of other possible objections from the Commission, by enacting in the State Budget Law for 2009 a solution that allowed payers of IRS resident in another Member State of the EU or the EEA, with which an information exchange system exists, to choose to be taxed under the rules applicable to those resident in Portuguese territory, provided that 90% of their total income in that year derived from employment, business or professional work or from pensions and are sourced (at this percentage) in Portuguese territory.

9. In 2007 the European Commission also opened a new battlefront, with a Statement in which it considered that the tax adjustment for financial assets not situated within Portuguese territory (RERT I), approved by the Portuguese Parliament in 2005 (Law no. 39-A/2005 of 29 July), by imposing a reduced tax rate for assets made up of Portuguese government bonds, as well as for the value of other assets reinvested in Portuguese government bonds, constitutes a restriction (by established discrimination) to the free movement of capital as guaranteed by the EU Treaty.



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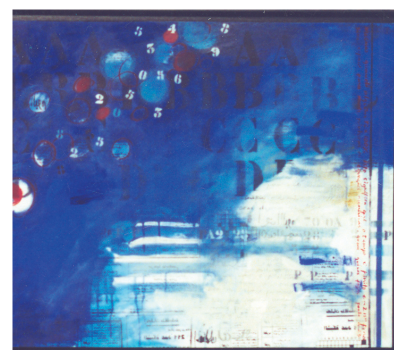

More specifically, the Commission indicated that RERT I established a preferential tax rate for the settlement relating to investments in Portuguese government bonds of 2.5 per cent as against the 5.0 per cent applicable to other assets.

In its opinion, investments related to a different Member State from that of residence should be taxed the same way as applies for those related to the Member State of residence (regardless of being in the context of tax amnesties).

In this way, and as the European Commission concluded, anyone who wanted to benefit from the amnesty was thus dissuaded from keeping their adjusted assets in forms other than Portuguese government bonds. In this context, in January 2008, the European Commission issued a Communiqué in which it announced its decision to refer Portugal to the CJEU.

10. Also, in May 2007 the Commission raised a potential problem of tax discrimination that could affect interest payments and dividends on foreign pension funds in relation to among several Member States including Portugal.

A year later, in May 2008, the European Commission sent a reasoned opinion, questioning those rules.

Given that Portugal did not amend its legislation in line with the European Commission's request, in November 2008 the Commission also announced its intention to take legal action against Portugal at the CJEU.

IV) Conflicts that started in 2008

11. In February 2008, the Commission asked Portugal to end discrimination against investments held abroad (following on from what it had done specifically with reference to RERT in 2007), recalling that the CJEU had already ruled, in the "Van Hilten" case, that measures taken by Member States that are liable to dissuade their residents from making investments in other Member States constitute a restriction on free movement of capital under the EU Treaty.

The issue is basically the potential for application of lower rates that the possibility of the aggregation option relating to capital income includes in certain situations.

12. Also in February 2008, the European Commission formally asked Portugal to amend its domestic legislation, this time in the field of indirect taxation, particularly as regards the special scheme for VAT applicable to travel agencies. The request was made in the form of a reasoned opinion, which is the second stage of infringement proceedings provided for in the EU Treaty.

The European Commission's position is based on the understanding that the non-uniform application of EU legislation in Member States may provide competitive advantages for the operators based in some of them, which is incompatible with the internal market.

In fact, the Sixth Directive included a special scheme designed to simplify the application of
VAT by travel agents who sell travel packages, including services, to

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Also in 2008 and by reasoned opinion, the European Commission formally requested Portugal to alter the tax provision that requires non-resident taxpayers to designate a tax representative if they earn taxable income in Portugal, as the Commission considered this to be incompatible with the free movement of people and capital established in the EU Treaty and the EEA Agreement.

travellers. However, the scheme does not apply to travel agents selling holiday packages to other taxpayers, including travel agents who resell travel services. Although in 2002 the Commission itself proposed extending the special scheme that was in place in order to cover sales to travel agencies, Member States have not reached agreement on such an extension.

But the main reason the Commission put forward to justify the proceedings initiated against Portugal and other Member States relates to the application of special arrangements by the Member States concerned in cases in which the customer is a taxpayer who resells travel services. The scheme should only be applicable in cases in which the customer is the traveller.

13. Moreover, the European Commission decided to refer Portugal to the CJEU because of domestic provisions that required the "administrative support document" to be sent to the competent customs office at least six hours prior to the products subject to excise duty leaving the warehouses in its territory. However, according to the Commission, the relevant EU legislation (article 19 of Directive 92/12/EEU) should not be construed as authorising Member States to impose such a condition, by which the Commission concluded that the Portuguese legislation as it existed in 2008 could jeopardise the functioning of the internal market by being clearly disproportionate to it with the goal of combating tax fraud.

The Commission also considered that the value of collateral required of authorised depositories (which came to 2% of the average monthly amount of excise taxes paid the previous year, with a minimum and maximum) was disproportionate in relation to intended purpose of protecting the revenue potentially at risk, creating an obstacle for traders wishing to enter the Portuguese market.

In July 2007 the Commission sent Portugal a reasoned opinion. However, since Portugal did not change the legislation concerned within the given time limit, the Commission referred the case to the CJEU. However, the case was brought to an end on 14 May 2009 because Portugal finally changed its domestic legislation to comply with the understanding of the European Commission.

14. Also in 2008 and by reasoned opinion, the European Commission formally requested Portugal to alter the tax provision that requires non-resident taxpayers to designate a tax representative if they earn taxable income in Portugal, as the Commission considered this to be incompatible with the free movement of people and capital established in the EU Treaty and the EEA Agreement.

Given that Portugal did not respond to the reasoned opinion sent by the European Commission in June 2008, nor did it change the law in question, the Commission decided to take legal action against Portugal at the CJEU on 19 February 2009.

15. Again in 2008, the Commission asked Portugal to cease the discriminatory treatment constituted by the income tax exemption applied exclusively to prizes from games operated by the Santa Casa da Misericórdia de Lisboa. However, these proceedings ended up being brought to an end on 29 October 2009, because Portugal amended its law to comply with the view expressed by the Commission.

16. In July 2008, the Commission issued new proceedings against Portugal concerning the difference in the periods of suspension of vehicle taxes granted to registered and recognised traders, which, according to the Commission, amounted to discrimination in relation to vehicles produced in other Member States.

In fact, under the domestic legislation in force at the time, a registered trader (a person habitually engaged in the production, admission [to the country] or importation of taxable vehicles) could keep a vehicle with tax suspended for a maximum period of three years, whereas a recognised operator (a person who, not meeting the conditions to qualify as a registered trader, is usually devoted to trade in taxable vehicles) could only keep a vehicle in the same scheme for a period of six months.

Vehicles manufactured in Portugal could only be supplied by registered traders, while vehicles produced outside Portugal, new or used, could be marketed by both registered operators and recognised by operators.

According to the European Commission the result of this is that the far less favourable maximum period of six months suspension of tax would never apply to new cars manufactured in Portugal, and the Commission found this to be a violation of the Treaty as regards the prohibition of discrimination against products from other Member States.

However, Portugal has already changed domestic legislation in accordance with the Commission's view, which led to the closure of the case on 14May 2009.

17. In November 2008, the European Commission formally requested, by reasoned opinion, that Portugal amend its legislation imposing an immediate "exit" tax, that is, a tax on profits or potential profits, when companies move their tax domicile out of Portugal, or transfer (in the case of permanent establishments of

non-residents) their assets to another Member State or cease their activities in Portugal.

In the opinion of the European Commission, this legislation violates the principle of freedom of establishment, in that it penalises companies that want to move their tax domicile to another Member State or transfer assets abroad, affording them a less favourable treatment than for companies who remain domiciled in the country or transfer their assets internally.

The Commission's opinion is based on the interpretation of the CJEU Case "Lasteyrie du Saillant" and the Commission's Communiqué on exit taxation (COM (2006)825) of 19 December 2006).

Since Portugal did not amend its domestic law by the deadline established for that purpose by the Commission, the latter referred the case to the CJEU on 8October 2009.

v) Conflicts that started in 2009

18. On 25 June 2009 the European Commission requested that Portugal amend its domestic legislation as Portugal was not applying a flat-rate scheme for farmers consistent with the objectives set out in the VAT Directive, since farmers who opted for the scheme could suffer financial disadvantages. The request took the form of a reasoned opinion (the second stage of infringement proceedings provided for in the EU Treaty).

Portugal established an optional provision for agricultural activities, which exempts from VAT products supplied by the farmer, unless he or she chooses to apply the normal provisions relating to VAT. Moreover, the proportion of flat-rate compensation is fixed at zero: farmers are not compensated for the VAT paid for production inputs, which can amount to 5-12%.
As such, Portugal applies substantial negative compensation to the EU's own resources to compensate for this factor. However, it is the view of the Commission that Portugal must stop applying "zero compensation".

Capital gains or losses will be determined as the difference between the market value of shares received and the book value of the shares released.

On 18 March 2010, the Commission decided to refer the matter to the CJEU, because Portugal had not amended its domestic legislation and the response sent to the Commission in September 2009 was considered unsatisfactory.

19. On 29 October 2009, the European Commission requested that Portugal amend its provisions that impose an exit tax on individuals, considering that such provisions are inconsistent with the free movement of people. The Commission's request takes the form of a reasoned opinion, which corresponds to the second stage of infringement proceedings under the EU Treaty.

Indeed, the personal income tax code (IRS Code) provides that gains or losses arising from exchange of shares will be included in taxable income of the shareholder for the calendar year in which he or she ceases to be resident in Portuguese territory. Capital gains or losses will be determined as the difference between the market value of shares received and the book value of the shares released. However, if the shareholder making an exchange of shares keeps his/her residence in Portuguese territory, the value of the shares received corresponds to the value of those released, there only being an increase in value if there is an additional payment in cash.

Also under the IRS Code, transfer from an individual to a company of assets and liabilities related to the exercise of a trade or profession is exempt if the organisation to which the assets and liabilities have been transferred has its registered office or effective management in Portugal, but taxed if the entity has its registered office or effective management abroad.

According to the Commission, this immediate taxation penalises those who want to leave Portugal or transfer their assets out of the territory as they are subject to less favourable treatment than individuals who remain in the country or transfer assets internally, thus constituting a restriction on the EU Treaty regarding the free movement of persons and freedom of establishment as well as the corresponding provisions of the EEA Agreement.

The Commission's opinion is based on the EU Treaty as interpreted by the CJEU in the judgement 11of March 2004 (Case C-9/02, "De Lasteyrie du Saillant") and the Commission Communiqué on "Exit taxation and the need for coordination of tax policies of the Member States" (of 19 December 2006).

vi) Conflicts that started in 2010

20. On 28 January 2010, the European Commission called on Portugal to amend its legislation on the annual road tax on motor vehicles. The Commission's request was made through a reasoned opinion under the EU Treaty, so named since the Treaty of Lisbon.

In Portugal, due to a comprehensive reform of vehicle taxation, domestic legislation determines that (annual) road tax on two similar used cars is calculated differently, depending on whether the cars were first registered in Portugal before or after July 1, 2007. In general, cars first registered in Portugal as of July 1, 2007, are

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In March 2010 the European Commission once again asked that Portugal amend its domestic legislation on direct taxation as the Commission considered it to be disproportionate, discriminatory and contrary to the fundamental freedoms enshrined in the EU Treaty.

subject to an annual road taxes higher than those registered before that date, due to a difference in the way of calculating the tax.

While the Commission indicates that it appreciates Portugal's efforts to amend its legislation on car taxation to take into account the pollution caused by emissions of CO_2, the position of the CJEU is that a car becomes "a Portuguese car" when it has been imported and sold domestically, whereas there is violation of the EU Treaty when the taxation of imported cars and similar domestic cars is calculated differently and based on different criteria, leading to a higher tax for the imported product. The Commission believes that this is exactly what is happening in the Portuguese case.

21. In March 2010 the European Commission once again asked that Portugal amend its domestic legislation on direct taxation as the Commission considered it to be disproportionate, discriminatory and contrary to the fundamental freedoms enshrined in the EU Treaty. The formal opinion of the European Commission protests against the Portuguese tax rules regarding taxation of income received by non-resident taxpayers.

Indeed, in relation to IRS (personal income tax) non-residents are subject to taxation based on calculation of gross amounts and flat rates, while residents are taxed on amounts net of specific deductions and are subject to progressive rates. In the view of the commission, these differences can lead to less favourable tax treatment of non-residents in relation to resident taxpayers, contrary to the freedom to provide services and freedom of movement of capital.

The internal rules that the Commission sees in a negative light establish: the exclusive application to residents of the rules for determining taxable income by aggregation of income received regarding IRS, with the possibility of benefiting from deductible expenses; the exclusion of non-residents from the scope of progressive taxes provided for resident taxpayers; and, finally, the subjecting of non-residents to withholding taxes and special rates on the gross income earned in Portugal.

It is to be expected that Portugal will reiterate the arguments already raised against previous warnings from the European Commission, namely the need for such measures to combat tax fraud and the fact that they are not applicable to taxpayers residing in Member States of EU and EFTA/EEA countries with which there is an information exchange system for tax matters (because the IRS Code establishes an optional tax regime for these taxpayers, with rules similar to those existing for residents).

Nevertheless, the European Commission believes that these measures discriminate against taxpayers belonging to Member States with which no information exchange system exists.

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