Euro Tax Flash

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CJEU decision in the Brisal case

Freedom to provide services - Withholding Tax – Taxation on a Net Basis – Deductible Expenses - Neutralization of discrimination

On July 13, 2016, the Court of Justice of the European Union (CJEU) rendered its decision in the Brisal case (C-18/15). This case concerns whether the Portuguese withholding tax on interest paid to non-resident financial institutions is contrary to EU law because it is imposed on the gross amount of the interest paid, whereas resident financial institutions are taxed on their net income. The CJEU concluded that the Portuguese legislation constitutes a restriction of the freedom to provide services which is not justified. In addition, it ruled that financing costs should, in principle, be deducted for non-residents, under the same conditions as for residents.

Background

Under its domestic law, Portugal imposed a 20 percent withholding tax on interest paid to non-residents, which in the case at hand was reduced to 15 percent under the relevant tax treaty. The tax is withheld from the gross amount, without any deduction for the costs of business expenses, such as the costs of financing the underlying loans. Portuguese residents, on the other hand, were subject to 25 percent corporate income tax on their net income, i.e., after deduction of such expenses.

The European Commission had already challenged this tax treatment in 2010, arguing that it resulted in non-resident financial institutions being more heavily taxed than resident financial institutions and was therefore contrary to the free movement of capital and the freedom to provide services (Commission vs. Portugal C 105/08). The CJEU rejected the Commission's case without addressing the substantive issues, arguing that no concrete evidence had been put forward to support the calculations used as basis for the arguments.

In the case at hand, two companies Brisal – Auto Estradas do Litoral S.A. and KBC Finance Ireland used similar arguments to challenge the Portuguese tax. As a consequence, the Portuguese Supreme Administrative Court asked to the CJEU (1) whether the freedom to provide services precludes the Portuguese legislation which taxes non-resident financial institutions by means of withholding tax on interest with no possibility of deducting business expenses, whereas resident financial institutions are not subject to such withholding tax and may deduct business expenses related to the financial activity pursued, and (2) how those expenses should be determined.

The CJEU decision

Following the Opinion of the Advocate General, the CJEU first reiterated previously held case law that the application of a withholding tax, as a method of taxation, only to non-resident service providers whilst constituting a restriction on the freedom to provide services may be justified by overriding reasons of interest, such as the need to ensure effective tax collection. The CJEU further noted that resident and non-resident service providers are in a comparable situation, as regards the deduction of business expenses having a direct link with the economic activity they are pursuing. In this respect, banking services should not be treated differently from other services, because of an alleged impossibility to establish a direct connection between costs incurred and income received. Referring to settled case law on the application of net taxation principles, the CJEU went on to conclude that national rules, such as the Portuguese legislation at issue, which deny non-resident taxpayers the possibility to deduct business expenses when taxing their gross income, whereas resident taxpayers are taxed on their net income, constitute a restriction of the freedom to provide services.

The CJEU further considered, but rejected, a number of possible justifications. It first recalled that a disadvantageous tax treatment, which is contrary to a fundamental freedom cannot be justified by other potential tax advantages, such as the application of a lower tax rate to non-resident taxpayers The CJEU then considered that the allocation of powers to tax cannot justify that non-resident financial institutions are treated less favorably than resident ones, and noted that the Portuguese government did not bring sufficient evidence that such treatment is necessary to prevent the double deduction of business expenses. The CJEU finally concluded that the effective collection of tax and the alleged administrative difficulties that would result from granting deductions to non-residents cannot justify the restriction at issue.

As regards which business expenses should be considered as directly related to interest income, the CJEU pointed out that, in principle, the deductible expenses to be taken into account must be the same for residents and non-residents. In this respect, the business expenses directly related to the income are the expenses occasioned by the financing activity, and therefore necessary for pursuing it. Such expenses in principle include financing costs and general expenses even if it is difficult to provide evidence establishing such a direct link. the CJEU pointed out in this respect that tax authorities may require non-residents to provide the documents necessary to determine whether the conditions for deducting expenses are met.

The CJEU finally concluded that it is for the referring court to determine to which extent the business expenses (including general expenses) may be regarded as directly related to the financial activity in the main dispute. For this purpose, the latter cannot take into account the average interest rates charged on interbank financing (unless these are also used for resident financial institutions) since they do not correspond to the financial costs actually incurred.

EU Tax Centre comment

As regards the basic question whether denying a non-resident the right to deduct directly related business expenses is a restriction, the decision largely follows the AG's opinion and is in line with previous case law.

As regards the determination of expenses "directly linked" to the non-resident's financial activities, it is interesting to note that the CJEU did not refer to the *Miljoen, X and Société Générale* cases (C-10/14, C-14/14, and C-17/14) (ETF 256), in which it had previously adopted a very restrictive interpretation as to which costs should be considered deductible. This position could be interpreted as an indication that the Court is not willing to confirm its decision in the *Société Générale* case as a turning point and will instead follow its previous case law.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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