Tax administration practice and European Union Law

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1. The structure of the tax administration in Portugal

The Portuguese tax administration essentially comprises the Directorate-General of Taxation (DGCI) and the Directorate-General of Customs and Excise, both of which form part of the Ministry of Finance.

The Directorate-General of Taxation (hereinafter "DGCI") has the mission of administering taxes on income, property and consumption, as well as other levies which may be attributed to it by law from time to time.

The mission of the DGAIEC, on the other hand, involves the control of the outer Community border and the national customs territory for tax and economic purposes and for the protection of society, namely within the scope of public culture, safety and health, and also administers the special consumption taxes.

These two directorates-general are scheduled for merger in the short term in line with the commitment undertaken to the Troika by the Portuguese government (Memorandum of Understanding entered into on 17 May 2011 between the Portuguese government and the Troika "Memorandum of understanding on specific economic policy conditionality".

However, even prior to undertaking this commitment, the government had already announced its intention to go ahead with this merger.

2. The tax administration and the laws of the EU

This Report deals with the issue of how administrative practice co-exists with European law. In this context, we shall analyse the compatibility of Portuguese legislation with the provisions of European Union law from an *ex ante* perspective, that is to say, to what extent European Union rules influence national legislation, and *ex post,* ascertaining to what extent their

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practical application by the tax administration complies with the provisions of European Union law.

For the purposes of this study, we have chosen to list some of the more recent infringement proceedings involving Portugal, describing the current state of affairs and some pro-active adaptations of national provisions by the tax administration.

3. Infringement proceedings

3.1. Cases pending in the Court of Justice

3.1.1. Travel agencies

An infringement proceeding concerning the non-conformity of Portuguese VAT legislation with the so-called "special profit margin regime" applicable to travel agencies when they sell package holidays to tourists is pending in the European Court of Justice after being filed by the European Commission in 2011 against Portugal (and seven other member states). The Commission claims that Portugal applies these special provisions incorrectly, thereby leading to distortions of competition between travel agencies.

This issue turns on the fact of this regime not applying to travel agencies which sell holiday packages to other companies, particularly other travel agencies, for resale purposes.

The eight member states called to the Court, according to the Commission, are not implementing the regime correctly, very often applying it to sales between travel agencies. This gives rise to competition distortions between travel agencies, meaning that some of these agencies have to shoulder a higher tax burden than others.

3.1.2. Outbound taxation on dividends

In June 2010, the Commission filed proceedings in the ECJ against Portugal and two other member states for discriminatory tax provisions.

In the Portuguese case, the issue is the imposition of Portuguese income tax on outbound dividends. According to the Commission, Portuguese tax legislation may, in certain cases, impose a higher rate of tax on dividends paid to foreign companies (outbound dividends) than on dividends paid to national companies (national dividends). While the legislation provides for a

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zero or very low percentage for the taxation of national dividends, a withholding tax which may be as high as 20% is imposed on outbound dividends. The Commission believes that these provisions restrict the movement of capital and freedom of establishment and may constitute a breach of the case law of the Denkavit judgment[2], in which the Court confirmed the principle that outbound dividends cannot be liable to a higher rate of taxation than national dividends in the source country.

3.1.3. Flat rate of tax for farmers

In March 2010, the European Commission decided to refer to the Court of Justice a proceeding relating to the flat rate of VAT applicable to framers.

Under the VAT Directive, if the application of the general VAT provisions to farmers is capable of bringing about difficulty, the member states may apply a flat rate aimed at offsetting the VAT charged on goods and services purchased by the farmers. The Commission claims that instead of introducing a flat rate for the farmers, Portugal established an optional provision for agricultural activities, which gives a VAT exemption to the products supplied by the farmer, unless the latter opts for the application of the normal VAT provisions. Further, the farmers are not compensated for the VAT paid in respect of production factors which may range from 5 – 12%. In these terms, the Commission considers that the flat-rate regime applicable to agricultural producers in Portugal conflicts with the objective of the regime and is not in conformity with the VAT directive.

3.1.4. Taxation of income obtained by non-residents

In March 2010, the European Commission once again urged Portugal to amend its internal legislation on direct taxation as it considers it disproportionate, discriminatory and contrary to the fundamental freedoms enshrined in the EU Treaty. The formal opinion of the European Commission criticises Portuguese tax provisions on the taxation of income obtained by non-resident taxpayers.

Effectively, non-residents are liable to personal income tax (IRS) which is calculated on the basis of gross amounts and fixed rates, while residents

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[2] ECJ 14 December 2006, case C-170/05, *Denkavit*.

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are taxed on the basis of net amounts after specific deductions and are liable to progressive rates. In the Commission’s view, these differences can lead to less favourable tax treatment for non-residents than for resident taxpayers, thereby conflicting with the freedom of provision of services and the free movement of capital.

The internal rules which have attracted this negative appreciation on the part of the Commission stipulate: the exclusive application to residents of the rules determining the taxable income through the aggregation of income liable to IRS, with the possibility of benefiting from deductible expenses; the exclusion of non-residents from the scope of application of the progressive taxes for resident taxpayers; and, finally, the liability of non-residents to definitive withholding tax and special tax rates on gross income obtained in Portugal.

It is likely that Portugal will restate the arguments it has already used in previous procedures of the European Commission, namely the need for tax measures of this nature to combat tax fraud and the fact that these measures are not applicable to taxpayers resident in EU or EFTA/EEA member states with which there is an exchange of information in respect of tax matters (as the IRS Code sets down an optional taxation regime for these taxpayers with similar rules as those established for residents).

Nevertheless, the European Commission takes the view that these measures discriminate against taxpayers from member states which do not have the above-mentioned information exchange mechanism.

3.1.5. Vehicle tax

In January 2010, the European Commission urged Portugal to amend its legislation on the annual circulation tax for motor vehicles.

The Commission request was made in a reasoned opinion in accordance with Article 258 of the EU Treaty.

As the Commission noted, under the provisions currently in force in Portugal, the (annual) circulation tax for two similar second-hand vehicles is calculated differently according to whether the vehicles were registered for the first time in Portugal before or after 1 July 2007. Vehicles registered for the first time in Portugal after 1 July 2007 are, as a rule, subject to a higher

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annual circulation tax than those registered before that date, owing to a difference in the method of calculating the tax.

The difference in the annual circulation tax system was introduced in Portugal as part of an overall reform of vehicle taxation, which takes into account the pollution capacity of a vehicle as a criterion for determining the tax base. The vehicle registration tax was reduced and the annual circulation tax was increased. When introducing the new measures, the Portuguese legislators considered that it would be unfair that vehicles registered in Portugal prior to 1 July 2007 and, consequently, subject to a higher vehicle registration tax, would have to pay the new higher annual circulation tax.

As the Commission pointed out, the position of the Court of Justice as regards the taxation of imported second-hand vehicles is that a vehicle becomes "a national vehicle" when it has been imported and sold on the internal market.

According to the settled case-law of the Court, Article 110 of the Treaty is breached whenever the taxation of imported vehicles and the taxation on similar national vehicles are calculated differently using different criteria, thereby leading to higher taxes being levied on the imported product. The Commission is of the opinion that this is exactly what is happening in the case of Portugal.

3.1.6. Exit tax on individuals

In October 2009, the European Commission requested Portugal in a reasoned opinion to amend the restrictive exit tax provisions applicable to individuals as they were incompatible with the free movement of persons.

As the Commission noted, in accordance with Article 10(9)(a) of the Personal Income Tax Code (*Código do Imposto sobre o Rendimento das Pessoas Singulares* (CIRS)), gains or losses deriving from an exchange of shares will be included in the taxable income of the shareholder for the calendar year in which he/she ceases to be resident in Portugal. The capital gain or capital loss will be calculated as the difference between the market value of the shares received and the book value of the shares handed over, However, if the shareholder who swops the shares continues to reside in

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Portugal, the value of the shares received corresponds to the value of the shares handed over and there will only be a capital gain if there is an additional cash payment.

In addition, under Article 38(1)(a) of the IRS Code, the transfer, by an individual to a company, of assets and liabilities related to the pursuit of an economic or professional activity is exempt if the company or enterprise to which the assets and liabilities are transferred has its registered office or effective management in Portugal, but is taxed if the company or enterprise has its registered offices or effective management abroad.

The Commission considers that this immediate taxation penalises individuals who wish to leave Portugal or transfer their assets abroad, by treating them less favourably than individuals who remain in the country or transfer assets internally. Consequently, the Portuguese provisions in question are capable of dissuading individuals from exercising their right to free movement, thus constituting a restriction on Articles 18, 39 and 43 of the EC Treaty[3] and the corresponding provisions of the EEA Agreement.

The Commission's opinion is also based on the interpretation of the Court of Justice of the European Communities in De Lasteyrie du Saillant[4], as well as on its Communication "Exit taxation and the need for co-ordination of member states' tax policies"[5].

3.1.7. Exit taxation on companies

In October 2009, the European Commission filed an action at the Court of Justice against Portugal (and another member state) owing to their restrictive exit taxation provisions for companies which cease to be tax residents, considering them incompatible with the freedom of establishment provided for in Article 43 of the Treaty and Article 31 of the EEA Agreement.

As the Commission noted, under Portuguese law, if the registered office or effective management of a Portuguese company is transferred to another member state, or if a permanent establishment ceases its business activities in Portugal or transfers its Portugal-based assets to another member state,

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[3] Treaty on the functioning of the European Union (TFUE).

[4] ECJ 11 March 2004, case C-9/02, De Lasteyrie du Saillant.

[5] Communication "Exit taxation and the need for co-ordination of member states' tax policies" (COM (2006) 825, of 19 December 2006)

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the taxable income for the financial year in question covers all the unrealised capital gains in respect of the assets of the company, but not unrealised capital gains from national operations. Further, the directors of a company which transfers its registered office or effective management out of the country are liable to tax based on the difference between the net asset value (calculated on the transfer date and at market prices) and the acquisition price of the shares.

The Commission takes the view that this immediate taxation penalises companies that intend to leave Portugal or transfer their assets abroad, treating them less favourably than companies that remain in the country or transfer their assets internally. The provisions in question are therefore capable of dissuading companies from exercising their right of freedom of establishment, thus constituting a restriction of Article 43 of the EC Treaty and the corresponding provision of the EEA Agreement.

The Commission based its decision on the interpretation of the Court of Justice of the European Communities in *De Lasteyrie du Saillant*[6] and on the above-mentioned Communication on exit taxation[7].

3.2. Previous proceedings

It cannot be said that Portugal has been a good student with regard to the application of the general principles of European Union law. Indeed, the decisions of the ECJ have been unfavourable on a number of occasions already and many national provisions have had to be amended as a result of ECJ judgments applying the rules of the Treaty on fundamental freedoms and the principle of non-discrimination.

Some of the Portuguese provisions that have been regarded non compliant with EU law - either by the Court of Justice or the EU Commission - will be dealt with below.

3.2.1. Discriminatory taxation of non-resident taxpayers

In February 2009, the European Commission filed proceedings against Portugal at the Court of Justice for tax discrimination against non-resident

[6] ECJ 11 March 2004, case C-9/02, De Lasteyrie du Saillant.
[7] Communication “Exit taxation and the need for co-ordination of member states' tax policies” (COM (2006) 825, of 19 December 2006)

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taxpayers, owing to the tax provisions which oblige non-resident taxpayers to appoint a tax representative if they obtain taxable income in Portugal. The Commission considers this provision incompatible with the free movement of persons and capital guaranteed under Articles 18 and 56 of the EC Treaty as well as under Articles 36 and 40 of the EEA Agreement.

As the Commission noted, under Portuguese legislation, non-resident taxpayers who obtain taxable income in Portugal have to appoint a tax representative to represent them to the Portuguese tax authorities and guarantee the performance of their tax obligations. The Commission considers that this requirement is aimed at the payment of taxes and avoiding tax fraud, both of which are objectives of recognised public interest. However, the Commission believes that the general obligation imposed on non-residents to appoint a tax representative exceeds what is necessary to ensure the above-mentioned objectives, thereby hampering the free movement of persons and capital established under Articles 18 and 56 of the EC Treaty as well as in the EEA Agreement.

The Commission's opinion is also based on the judgment N. of 7 September 2006[8].

The ECJ ruled against Portugal in its judgment of 5 May 2011[9], which pitted Portugal against the European Commission. In the wake of this judgment, the 2010 State Budget Bill amended the legislation with a view to the obligation to appoint a tax representative being optional for non-resident taxpayers resident in an EU or EEA member state, in the latter case when there is a tax cooperation agreement, as well as for residents who are absent from Portugal for over six months in these states.

It should be noted that, in practice, the tax administration was already implementing the dispensation from the appointment of a tax representative in the situations referred to above.

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[8] ECJ 7 September 2006, case C-470/04, N.

[9] ECJ 5 May 2011, case C-267/2009, Commission vs. Portugal.

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3.2.2. Exceptional tax regularisation regime

At issue here was the judgment of 7 April 2011[10], which originated in an action filed by the Commission against the Portuguese State, in which it asked the Court of Justice to declare that the Portuguese State had failed to comply with Community legislation because of the Exceptional Tax Regularisation Regime created in 2005 (also known as RERT I), which made it possible to impose a more favourable rate for Portuguese government bonds or wealth reinvested in government bonds.

The court recalls that any measures imposed by a member state constitute restrictions on the free movement of capital when they are capable of dissuading residents from taking out loans or making investments in the other States.

In this respect, the Court takes the view that taxpayers who are holders of securities issued by the Portuguese Sate could have the benefit of preferential treatment, by virtue of the provisions of RERT I, vis-à-vis taxpayers who are holders of public debt issued by the other States.

Consequently, the ECJ considers that taxpayers who are holders of public debt issued by the Portuguese state receive more favourable treatment, which may dissuade taxpayers from investing in public debt securities issued by other member states, and there is a clear restriction on the free circulation of capital.

It should be pointed out that RERT II, an exceptional regime similar to RERT I and which was in force during 2010 (cf. Law 3-B/2010, of 28 April), did not include any provision similar to the one which was deemed to be in breach of the Community legislation in this ECJ judgement.

3.2.3. Different taxation for non-resident service providers

In 2007, the European Commission requested the Portuguese State in a reasoned opinion to put an end to the different taxation regime applicable to non-resident service providers in respect of income obtained in Portugal.

Resident financial institutions only pay tax on interest received, net of the charges borne for the loan principal to be made available.

[10] ECJ 7 April 2011, case C-20/09, Commission vs. Portugal.

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The main reason put forward by the Commission was not the existence of discriminatory treatment, unlike what would be the case in 2008 with regard to the exemption regime that benefited the winners of games run by the Santa Casa da Misericórdia de Lisboa.

In the Commission's view, this regime could become a dissuading factor for service providers established abroad who intend to carry on their business in Portugal and put Portuguese clients off acquiring services from these suppliers.

And in 2008, the Commission again confronted Portugal over this broader theme of Portuguese taxation on services provided by non-residents in a Communication in which it reiterates its decision to file an action against Portugal in the ECJ for discriminatory tax treatment against non-Portuguese service providers.

The Portuguese State embraced the recommendations of the Commission in the 2009 State Budget Law, amending the legislation in order to allow a resident in another member state of the EU or the EEA to apply for a tax refund of the amount of the tax deducted at source in excess of what would be owed by a resident in Portugal on income deriving from service provisions.

Portugal went still further in this field, anticipating other possible Commission objections, by including in the 2009 State Budget Law a provision that allows IRS taxpayers resident in another member state of the EU or an EEA member state with which there is an exchange of information, to opt for taxation according to the rules applicable to taxpayers resident in Portugal, provided that 90% of their total income in the year in question derives from employment, business or professional work or pensions and (that percentage) has its source in Portugal.

3.2.4. Accompanying administrative document

In 2008, the European Commission decided to refer Portugal to the ECJ on account of the national provisions which required that an "accompanying administrative document" be sent to the relevant customs office at least six hours before the products liable to special consumption taxes leave the warehouses situated on its territory. As the Commission understands it, the

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relevant Community legislation (Article 19 of Directive EEC/12/92[11]) cannot be interpreted so as to authorise the member states to impose such a condition and, accordingly, the Commission concluded that Portuguese legislation, in its 2008 shape, could compromise the functioning of the internal market by being clearly disproportionate to the objective of combating tax fraud.

The Commission also considers that the amount of guarantee required from the authorised depositaries (which amounted to 2% of the average monthly amount of special taxes on consumption paid in the previous year, subject to a minimum and maximum limit) was disproportionate to the desired objective of safeguarding income that was potentially at risk and constituted a barrier for operators that wanted to enter the Portuguese market.

In July 2007, the Commission sent Portugal a reasoned opinion. However, as Portugal failed to amend the legislation in question within the stipulated period, the Commission referred the case to the ECJ. The proceedings however ended on 14 May 2009 as Portugal amended its internal legislation in accordance with the understanding of the European Commission.

3.2.5. Income tax exemption solely for winners of games run by the Santa Casa da Misericórdia de Lisboa

In 2008, the Commission requested Portugal to end the discriminatory treatment whereby an income tax exemption applied solely for winners of games run by the Santa Casa da Misericórdia de Lisboa. The proceedings in question, however, were concluded on 29 October 2009 as Portugal amended the internal legislation in question in accordance with the understanding of the Commission.

3.2.6. The vehicle tax suspension granted to registered and recognised operators

In July 2008, the Commission instituted new proceedings against Portugal on account of the difference in the vehicle tax suspension periods granted to registered and recognised operators which, in the view of the Commission,

[11] Directive EEC/12/92 of 25 February 1992, on the general arrangements for products subject to excise duty, and on the holding, movement and monitoring of such products.

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amounted to discrimination against vehicles produced in other member states.

Under the internal legislation in force at the time, a registered operator (taxpayer habitually engaged in the production, admission or importation of taxable vehicles) could have tax on a vehicle suspended for a maximum period of three years, while a recognised operator (taxpayer who, although engaged in the trade of taxable vehicles, does not meet the conditions to become a registered operator) could only have a suspension period of six months.

Vehicles manufactured in Portugal could only be supplied by registered operators, while vehicles produced outside of Portugal, whether new or second-hand, could be sold by both registered and recognised operators.

It follows, according to the European Commission, that the disadvantageous maximum tax suspension period of six months would not apply to new vehicles manufactured in Portugal and, consequently, the Commission viewed it as a breach of the Treaty, more specifically a breach of the prohibition on discrimination against products from other member states.

Portugal amended the internal legislation in question in accordance with the understanding of the Commission, which led to the proceedings being dismissed on 14 May 2009.

3.2.7. Payment of interest and dividends to foreign pension funds

The Commission raised a potential tax discrimination issue, with several member states, including Portugal, which would affect the payments of interest and dividends to foreign pension funds.

One year later in May 2008, European Commission sent a reasoned opinion calling the above-mentioned provisions into question.

As Portugal did not amend its legislation in accordance with the request of the European Commission, in November 2008, the latter communicated its intention to file proceedings against Portugal at the ECJ.

3.2.8. Investments made abroad

In February 2008, the Commission requested Portugal to bring to an end the discrimination against investments made abroad (in the wake of what

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had been specifically done with reference to RERT I in 2007), recalling that the ECJ had already held in Van Hilten[12] that measures taken by the member states which are capable of dissuading their residents from making investments in other member states constitute restrictions to the free movement of capital provided for in the EEC treaty.

What is essentially at issue is the potential for an application of lower rates than those carried by the possibility of opting for aggregation - in certain situations - in relation to capital income.

3.2.9. Discriminatory treatment in relation to dividends paid to companies domiciled in the other member states and in the EFTA countries

In 2006, the Commission requested various member states, including Portugal, to bring to an end the discriminatory treatment on dividends paid to entities domiciled in the other member states and in the 3 EFTA countries that were party to the EEA Agreement. In 2007, it stated that it would file proceedings against various member states, including Portugal, based on the above-mentioned allegedly discriminatory treatment applied to the dividends paid.

In the 2008 State Budget Law, Portugal made provision for an IRS exemption on profits that a company resident in Portuguese territory, once the conditions established in the parent company directive had been met (EEC Directive 90/435/EEC[13]), placed at the disposal of a resident in another member state of the European Union or of a fixed establishment situated in another member state of a company resident in an EU member state, provided that requirements similar to those required in domestic situations have been met.

3.2.10. Exclusion of capital gains for main permanent dwellings

In 2005, the Commission filed proceedings against Portugal on account of the rules which only allow the exclusion of personal income tax from capital

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[12] ECJ 23 February 2006, case C-513/03, Van Hilten.

[13] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

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gains on the disposal of a main permanent dwelling, if the proceeds from the sale are reinvested in a main permanent dwelling situated in Portugal.
This provision was amended by Decree-Law 361/2007, of 2 November, thereby allowing reinvestment when the property is located in another member state of the European Union or the European Economic Area.

3.2.11. Taxation on income paid to non-resident companies

In 2005, the European Commission filed proceedings against the Portuguese State on account of the taxation of interest paid to non-resident companies which have no fixed establishment in Portugal, as it considered discriminatory the 20% withholding tax rates on gross interest paid to Portuguese residents who have taken out a loan from lenders that are not resident in the country.
Resident financial institutions only pay tax on income received, net of any necessary charges paid for the loan principal to be made available.
As the Commission saw it, this taxation of gross interest amounted to discrimination against foreign financial institutions which, as a result, saw the possibility of granting cross-border loans restricted and, at the same time, hindered (or prevents) the possibility of Portuguese citizens taking out loans (mortgage or otherwise) from such institutions.
In 2006, the refusal of the Portuguese State to amend its tax legislation on the payment of interest outside of Portugal led the Commission to announce that it would file an action in the ECJ based on the fact that Portugal had not complied with its opinion (Article 226 (2) of the EEC treaty) within the specified period, an action which was filed in March 2008.
A recent ECJ judgment relating to Belgian tax legislation on interest payments (*Truck Center*[14]) has allowed Portugal to glimpse significant chances of success in this dispute about interest payments, because it was stated that the "different procedures for charging tax [through deduction at source in the case of non-residents, or by filing a return in the case of residents] thus constitute a corollary to the fact that resident and non-resident recipient companies are subject to different charges [and] (…) those different taxation arrangements reflect the difference in the [non-

[14] ECJ 22 December 2008, case C-282/07, Truck Center.

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comparable] situations in which those companies find themselves with regard to recovery of the tax".

4. Application of the Business Taxation Conduct Code

Portugal has been an "exemplary student" in this area.

It was due to the work arising out of the Business Taxation Conduct Code and the rules related to state aid that the tax benefit regimes for contractual investment and the Madeira Duty Free Zone or Madeira International Business Centre were amended.

In the Portuguese case, out of the 14 measures that were initially classified as potentially negative[15] only one was actually "classed as negative" in the Primarolo Report of 1999 - the MIBC measure on financial services[16].

Portugal managed to prove that the remaining measures had no adverse effects, a fact which in the case of tax benefits for contractual investment meant the amendment of the regime. Effectively, in relation to this regime, then set down in Article 49 of the Tax Benefits Statute ("EBF") (current Article 39), doubts were raised essentially as to the lack of transparency of the regime in place at the time and as to the fact that the incentives are granted under contract, which may be discriminatory. Further, the regime favours foreign investments, giving rise to ring fencing situations.

In light of the questions raised, Portugal decided to amend the regime, making it transparent and extending it to national investments, having opted to discuss it first in terms of state aid.

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[15] As regards our country, the following tax regimes were under analysis - holding companies (Sociedades Gestoras (Category 1); Madeira and Santa Maria Free Zones and reinsurance companies (Category 2); shipping regime and tax credit for research and development expenses (Category 3); Industrial Free Zones and tax credit negotiable for restructuring projects in depressed areas (Category 4); micro and small companies, tax incentives for contractual investments, tax credit for investment, reinvested capital gains, business and real estate companies, accelerated depreciation and investment funds (Category 5) and East Timor and Macao (dependent or associated territories).

[16] Further, as noted in Footnote no. 8 of the Primarolo Report, Portugal never agreed with the assessment made of the financial activities regime of the MIBC. Contrary to the procedure set out in point G of the Code of Conduct (provision inserted in the Code through the intervention of the Portuguese and Spanish delegations) the issue as to proportionality of the measure vis-à-vis the desired economic objectives was never analysed, since the second report that was delivered by Portugal for the purpose was never discussed by the Group. Indeed, contrary to the procedure that was adopted for all the other reports handed in by other member states, the President concluded after the distribution of the report among the member states that silence would be taken as agreement as to the assessment of the measures as negative.

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Once the alterations to the measure had been approved by the Commission as compatible with the Community legal order, its appreciation in light of the Code of Conduct became much simpler.

5. Application of the rules on state aid

There are various cases of the application of the state aid regime to Portuguese tax measures, such as the Madeira and Santa Maria (Azores) Free zones, the tax benefits for contractual investments and the tax benefits for the interior and for the adaptation of the Azores tax system to the specific needs of the region.

In the case of the tax aid to the inland regions ("retrospective regime"), what happened was that the government did not notify the Commission before the regime came into force and, at the time, it did not conform to the rules on state aid. The Commission drew attention to the fact that what was at issue was a *de minimis* aid and, accordingly, it could not have the broad scope that was initially intended. In other words, Portugal was "invited" to adapt the regime to the rules on state aid, which is in effect what happened.

In the case of the Azores, the Commission took the view that part of the regime that adapts the national tax system to the specifics of the Azores, in relation to the application of lower IRC rates on financial activities, amounted to a state aid incompatible with the common market[17]. Effectively, under Article 37 of Law 13/98, of 24 February ("Regional Finances Law"), the Regional Legislative Assemblies are authorised to reduce the income tax rates which apply there by up to the 30% limits of the rates set out in the national legislation. By means of Regional Legislative Decree 2/99/A, of 20 January 1999, the Azores Region approved the ways of adapting the tax system to the regional specifics. Under this legislation, all IRS and IRC taxpayers in the Azores Region benefit from tax rate reductions which may be as high as 20% for IRS and 30% for IRC. Taking into account the characteristics of this aspect of the regime which

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[17] Directive 2003/442/EC, of 11 December 2002 on the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax, OJ L 150, of 18 June 2003, p.53.

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adapts the national tax system to the specifics of the Azores, the Commission observed firstly that the Guidelines on state aid with regional purposes enshrine the general principle of the prohibition on regional aid aimed at reducing the current expenses of companies (operating aids), while admitting exceptions in the regions which benefited from the derogation in Article 87(3)(a) o the *Treaty, "provided that it is justified in terms of its contribution to regional development and its nature and its level is proportional to the handicaps it seeks to alleviate".* The Commission considered, with regard to mobile activities, namely financial services and "intragroup service" or "coordination centre" type companies, that the reductions of the tax rates were not justified by their contribution to regional development, as they were not proportional to the additional costs they sought to compensate.

In a judgment of 6 September 2006[18], the court ruled against Portugal essentially on the grounds that the Azores regime amounted to a special regime vis-a-vis the regime on the mainland and not a general regime in place in this Region. This fact is rooted in considerations as to the degree of autonomy of the Region and the decision refers only to the application of the IRC rate on financial activities which, as stated above, according to the Commission Guidelines, are mobile activities which do little to favour local development and are not as a rule proportionate to the economic objectives desired with the grant of such benefits.

6. Some cases of pro-activity on the part of the tax administration

In some cases and with ever-increasing frequency, the Portuguese tax administration has acted proactively and amended its legislation or its administrative interpretation based on the case-law of the ECJ.

6.1. IVA – The relationship between companies and branches

The tax administration has embraced the case-law in the *FCE Bank* judgment[19] in Portugal through Official Circular No. 30114, of 25 February 2009, considering that the concept of independence on which the capacity

[18] ECJ 6 September 2006, case C-88/03, Commission vs. Portugal.
[19] ECJ 23 March 2006, case C-210/04, FCE Bank.

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of a taxable person is conditional implies that when there is a subordinate relationship comparable to the one created by an employment contract between employer and employee, the latter does not act in the capacity of taxpayer when providing the services.

As a consequence, it considers that, within the same legal entity, a fixed establishment may or not have sufficient autonomy to act on its own account, on its own responsibility and bear the economic risks of its activity alone, thus taking on the capacity of taxpayer for VAT purposes or otherwise.

6.2. Undercapitalisation rules

In Portugal, three fundamental requirements apply to the undercapitalisation rules contained in Article 67(1) of the Corporate Income Tax Code (*Código do Imposto sobre o Rendimento das Pessoas Colectivas* (CIRC)): (i) the non-residence of the creditor in Portugal or another member state of the European Union, (ii) the existence of a "special relationship" between the creditor and the debtor, and (iii) the existence of "excessive indebtedness".

The residence requirement was altered by the 2006 State Budget Law, since it was not in conformity with Community provisions, more specifically the principle of non-discrimination and freedom of establishment, as the ECJ had decided in *Lankhost-Hohorst GmbH*[20] in respect of similar provisions existing in Germany. This amendment determined that the regime does not apply in the event of indebtedness to non-residents in Portugal or in another member state of the EU (up to then it had been limited to non-residents in Portugal).

6.3. Calculating the *pro rata* VAT

In the 2008 State Budget Law, Portugal changed the way that *pro rata* VAT was calculated after the judgment against Spain in *Commission v. Spain*[21].

Similarly to the case in Spain, the tax administration in Portugal took the view that if a taxpayer entitled to full deduction received a subsidy not directly related

[20] ECJ 12 December 2002, case C-324/00, Lankhost-Hohorst GmbH.
[21] ECJ 6 October 2005, case C-204/03, Commission vs. Spain.

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to the price of operations, he should adopt the *pro rata* method, thereby limiting his right to deduction.

7. Conclusions

Two distinct fields should be differentiated in administrative practice: the matters which are entrusted to the Directorate-General of Customs and Excise (DGAIEC) and the matters dealt with by the Directorate-General of Taxation (DGCI).

As previously stated, the taxes administered by the DGAIEC encompass two large central cores: customs duties and excise duties.

The former are governed by the Community Customs Code and, since administrative practice closely follows the line of Community law, it could be said that administrative decision basically consists in the application of Community Law.

However, the rules are not entirely one-sided and do allow for some leeway in interpretation, therefore sometimes leading to different outcomes in identical cases. This holds true as much for the administration as it does for the courts.

Nevertheless, the prevailing interpretations of Community provisions are upheld more often than not and decisions are, therefore, generally homogeneous, owing to the frequent meetings of the highest-ranking officers of the customs authorities of the EU.

The situation with regard to excise duties is very similar for the same reasons.

The applicable provisions of the IEC (Excise Duty Code) stem directly from Community law and the highest management levels of the DGAIEC maintain close information channels with their EU counterparts.

The laws on income tax or property tax are little influenced by European law, with the exception of those which result from the transposition into Portuguese domestic law of Community directives in very much their original form.

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The VAT legislation too follows the Community Directive very closely[22]. In fact, contrary to the situation in some member states of the EU, in Portugal there is a tendency on the part of the legislators to follow the directives to the letter and not being very creative when transposing them. Thus, for instance, there is no definition in our legislation of registered office, fixed establishment or domicile.

However, VAT is by nature an overlap tax, which is levied on legal acts and transactions which are very often not particularly well classified. While the VAT laws seek to refer to economic transactions and facts, these transactions and facts carry with them a certain legal classification, typical of Portuguese law, which may give rise to divergences with the true meaning of European law.

In short, it is in the taxes on income and property that the greatest discrepancies exist in relation to European law.

The European directives on these matters are few and somewhat flexible and accordingly allow significant room for free appreciation.

Generally speaking, European law, in this field, acts by way of indeterminate concepts: freedom of establishment, freedom of movement of workers and capital; non-discrimination, etc. These concepts need to be perfected and extended by the European courts, through decisions which it is often difficult to apply across the board.

In conclusion, we may state that, on the one hand, the conformity of the actions of the tax administration to the European Union legal rules is seen with greater intensity in the field of legal acts and with less intensity as regards the general principles of European Union law.

In relation to the transposition of legal acts, there is a certain tendency to transpose these almost literally and, as a rule, there is a high degree of compliance with the respective purposes and content, although in practice there may be some lack of conformity in the application of the European rules (as is the case with VAT).

As for the transposition period, Portugal has taken more time than the other member states of the EU.

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[22] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

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Portugal does not pay the constant attention to the decisions of the European courts which characterises some of the member states, however, there has been a good deal of improvement over the last few years, and there is a growing concern on the part of the tax administration to support the *acte clair* theory.

In various cases, the tax administration has proactively embraced the relevant decisions of the ECJ without having been urged to do so by the European Commission or the ECJ, either through legislative amendments or administrative instructions. We can conclude that the Portuguese tax administration keeps abreast of the major decisions of the European courts and follows them to some extent in their practice.

Further, the reference for a preliminary ruling is not much used by our courts and, accordingly, Portuguese law and practice on taxes, income and capital remain relatively unaffected by European law. However, this has also been the case with regard to VAT, though to a lesser extent, and there is greater care regarding compliance with the legal provisions of the European Union.

We may however state that referrals from Portuguese tax courts on tax issues to the European courts are in line with the European percentage.

Generally speaking, the Portuguese administration follows the tax rules of European Union law and has transposed the vast majority of the legal acts by which it is bound, although there have been some delays.

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