CFC Rules in Portugal: Still Incompatible with EU Law?

The author discusses Portugal’s CFC rules following the first amendments subsequent to the Cadbury Schweppes decision, introduced by the Budget for 2012. The author notes that, while an attempt was made to make the rules EU law compliant, it appears an entirely new set of problems has been introduced.

1. Introduction

Following the ECJ’s decision in Cadbury Schweppes (Case C-196/04),1 several Member States amended their controlled foreign company (CFC) rules in order to make them compatible with EU law. Portugal was, however, one of the few Member States that (apparently) ignored the problem, although Portugal had been alerted to the problem and was aware amendments were needed.2 Only recently, in the State Budget for 2012, were initial post-Cadbury Schweppes changes introduced. At first glance, they seem to be aimed at ensuring compliance with EU law. Nonetheless, a more comprehensive analysis reveals that, besides not achieving that goal, the new regulation introduces a whole new set of problems. In this article, the author discusses the new Portuguese CFC rules, highlighting some of the intricacies of the regime, and attempts to ascertain if the new rules are, finally, EU compliant.

2. The New Portuguese CFC Rules – A Brief Overview

2.1. Introductory remarks

In general, CFC rules are triggered when three cumulative conditions have been met: (1) the subsidiary is located in a territory with a “clearly more favourable tax regime”, 3 (2) the participation exceeds a certain threshold and, because of that, “control” is deemed to exist, and (3) the subsidiary derives its income from a specific set of activities. Sections 2.2. to 2.4. explore these requirements.

2.2. The level of taxation

The following three types of criteria are used in determining whether or not a subsidiary is considered to be located in a clearly more favourable tax regime: (1) the blacklist criterion; (2) the comparative qualitative method and (3) the comparative quantitative method.

In regard to the first, mere residence in a jurisdiction that is included in the list is sufficient, regardless of the specific characteristics of the subsidiary.4 For the second, the subsidiary will qualify if it does not pay, in its residence state, a tax that is “identical or similar” to the Portuguese corporate income tax (CIT). In respect of the third category, a subsidiary will qualify if the tax effectively paid in its residence state is 60% or less in comparison with the tax that would effectively be payable in Portugal.

The rationale behind this rule is clear: it is aimed at avoiding the deferral or absence of taxation of certain types of income through the use of subsidiaries located in low-tax jurisdictions. However, the automatic and blind application of the CFC provision to all companies seated in blacklisted jurisdictions, regardless of the level of taxation that they effectively face or the commitments of those jurisdictions in terms of exchange of information, seems odd.5 Accordingly, and in the author’s opinion, it would be better if the blacklist were used for interpretative purposes, triggering a presumption of low taxation that could be rebutted if the taxpayer proved that it effectively faces a tax burden higher than 60% of the burden it would suffer in Portugal.

In the past, the issue of compatibility with EU law has been raised, as Member States (Cyprus and Luxembourg)6 had...
been included on the list prior to the most recent amendment. This question is now irrelevant. ⁷

One should note that, in contrast to thin capitalization rules, there is no general exclusion of intra-EU situations. In fact, it is likely that the exercise of the freedom of establishment by relocating to a low-tax EU jurisdiction will trigger the CFC rules. ⁸

2.3. Control

Control is deemed to exist when (1) the resident company holds, directly or indirectly, at least 25% of the non-resident company located in a low-tax jurisdiction or (2) when the resident company holds more than 10% of the shares and 50% or more of the non-resident company is held by resident shareholders. ⁹ In addition to direct participations, indirect participations also qualify, i.e. those held through a representative, trustee or intermediary.

In the second case, in particular, CFC rules might apply even in circumstances where no control is exercised, ¹⁰ thus making the Portuguese rule one of the most penalizing CFC rules in Europe.

2.4. Type of income

Income will not be subject to the CFC rules if: (1) more than 75% of the income obtained by the non-resident company is from agricultural or industrial activities or from a commercial activity that does not involve residents in Portugal (or at least is mainly directed at the market where it is established); ¹¹ and (2) the non-resident company’s main activity is not banking or insurance activities or operations generating passive income. ¹² The purpose of this condition is to limit the rule to “genuine” activities. Nonetheless, the connection between (1) income from an active activity and genuineness and (2) income from a passive nature and artificiality is tenuous.

3. Safeguarding the CFC via a “Bona Fide” Clause

3.1. Introductory remarks

The technique used in order to make the CFC rules compatible with the Treaty on the Functioning of the European Union (TFEU) (2007) ¹³ (and with the EEA Agreement) was the introduction of a bona fide clause. As a result, CFC rules will never be applicable if the resident shareholder provides evidence that: (1) there are “valid commercial reasons” (VCRs) for the establishment and operation of the entity and (2) the foreign-source income is derived from an economic activity of an agricultural, commercial, industrial or service nature. Both requirements have to be met in order for the exclusion to apply.

This section of the article (i.e. section 3) discusses the compatibility of this clause with EU law, with the EEA agreement and, more specifically, with ECJ case law, in particular, the decision in Cadbury Schweppes.

3.2. Valid commercial reasons as the prime CFC bona fide clause

The VCR concept clearly has an EU source, as it is derived from the anti-abuse provision in article 15(1)(a) (ex article 11.1.a) of the Merger Directive (09/133). ¹⁴ In the 2009-2011 period, this concept was the subject of heated debate before the Portuguese courts and among scholars, as it was the core element of the decision in Foggia (Case C-126/10). ¹⁵ In that decision, the ECJ ruled that there are VCRs only when there are more than just tax reasons for the transaction. The discussion surrounding the Foggia case explains why the VCR concept was introduced as the prime abuse criterion for CFCs.

Given its novelty, ¹⁶ and as the decision was published after the presentation of the draft budget bill, the legislator could not have anticipated such a concrete ruling of the court. Nevertheless, and within the framework of EU taxation, it is quite clear that the court uses this criterion in order to ascertain abuse in the context of harmonized taxation and, more specifically, in regard to the Merger Directive (2009/133). Moreover, the court was clear in distinguishing this concept from the criteria used in regard to non-harmonized direct taxation: wholly artificial arrangements (WAAs).

3.3. Wholly artificial arrangements (WAAs) versus valid commercial reasons

The WAA concept is the ECJ’s benchmark in assessing the compatibility of a prima facie discriminatory or restrictive domestic tax regulation, which is justified by the need to fight tax fraud and evasion, with EU law. The court has consistently stated that such a measure, aimed at achieving this objective, can only be upheld if it is proportional, i.e., if it does not go beyond what is necessary to tackle “wholly artificial arrangements”.

Following Cadbury Schweppes, ¹⁷ taking advantage of a more favourable tax system of another Member State is...
not, in itself, a form of abuse. What needs to be verified, in terms of the subjective element, is whether or not an actual establishment exists that is intended to carry on genuine activities in the host Member State, which must be based on objective factors ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment. 18

The ECJ concluded that CFC rules, when applied in intra-EU cross-border cases, can amount to discrimination. They can only be maintained if they are justified and proportional. This would be the case if they restrict their scope to WAA.

The mere fact that an entity wants to benefit from a more favourable tax regime of another Member State does not amount to abuse and does not justify the restriction of fundamental freedoms that is caused by CFC rules. Therefore, the application of CFC rules is always an exception, the necessity of which should be demonstrated.

According to Cadbury Schweppes, “[t]he fact that a Community national, whether a natural or a legal person, sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty”. 19 Moreover, “the fact that the company was established in a Member State for the purpose of benefitting from more favourable legislation does not in itself suffice to constitute abuse of that freedom” 20 and lastly, “the fact that in this case CS decided to establish CSTS and CSTI in the IFSC for the avowed purpose of benefitting from the favourable tax regime which that establishment enjoys does not in itself constitute abuse. That fact does not therefore preclude reliance by CS on Articles 43 EC and 48 EC”. 21

In this case, the ECJ reviewed the exercise of the Member States’ jurisdiction in the area of non-harmonized direct tax in light of EU law, in particular, the interference of a domestic tax provision in the exercise of a fundamental freedom.

In the context of harmonized direct taxation (for example, Foggia), the ECJ applies a more strict test, i.e. abuse, and the concept of VCR is considered only within the framework of a specific directive.

It is quite clear that, in cases involving harmonized direct taxation, the court takes a different approach in comparison to its position in regard to abuse in the context of the fundamental freedoms (i.e. non-harmonized taxation). In the latter case, such as that mentioned in Cadbury Schweppes, the abuse concept is very narrow and aimed at avoiding or limiting cases where the exercise of a fundamental freedom is not effective or is based on artificial constructions. In contrast, the notion of abuse in the field of the Merger Directive (2009/133) is much wider, and a state can withdraw the benefits of the Directive in all cases where no “valid commercial reasons” exist. In the court’s words, “where the merger operation has the sole aim of obtaining a tax advantage and is not carried out for valid commercial reasons, such a finding may constitute a presumption that the operation has tax evasion or avoidance as one of its principal objectives” and “a merger by way of exchange of shares having only such an aim cannot therefore constitute valid commercial reasons”. 22

The Merger Directive (2009/133) is intended to grant benefits to EU citizens, specifically the deferral of taxation of capital gains. The limitation provided in the Directive – VCR – was conceived to prevent abuses in regard to that particular type of economic transaction (reorganizations), in a specific area of taxation (corporate income tax), to minimize potential distortions caused by the fact that, traditionally, internal corporate reorganizations are neutral whereas cross-border reorganizations would normally be taxed. The rule, i.e. article 15(1)(a) of the Directive, is, therefore, specifically aimed at preventing abuse in the cases specified in the Directive. To extrapolate such anti-abuse rules in order to delimit the exercise of fundamental freedoms provided in the TFEU (2007) is, at the very least, extremely inappropriate.

3.4. Main problems arising from the use of a harmonized direct taxation concept in a non-harmonized context

A resident company controlling a non-resident company (based in a Member State or in the European Economic Area (EEA)) is subject to the Portuguese CFC regime unless it shows that there are VCRs. 23 Therefore, the concept of VCR was implemented into the Portuguese CFC provision for the purpose of ascertaining abuse in a specific profile of cases concerning non-harmonized taxation. A resident company wanting to avoid the application of the CFC rules has to show that it had VCR for acquiring “control” 24 of the non-resident company.

Due to this wording, and in cases covered by the fundamental freedoms, the Portuguese legislator has determined that abuse exists not only when the subsidiary amounts to a WAA but also when the resident cannot prove that the acquisition of the shares in the non-resident company was based on valid economic reasons.

If no evidence is adduced on the existence of VCR, the CFC anti-abuse rule is applied, which amounts to what appears to be an unacceptable blind presumption of tax fraud and evasion. In this context, and according to the new wording, in CFC situations, tax motives are no longer legal motives.

Moreover, a question arises: specifically in cases where the holding is minimal (it should be recalled that a 10% holding can trigger the CFC regulation, even if no control is effectively exercised) what are the VCRs? How can I prove that I have acquired a portfolio participation for a
The case law is clear in that, with regard to non-harmonized direct taxation, there is abuse only in cases of WAA. Further, a domestic tax provision that is not restricted in its effects to those arrangements goes beyond what is necessary to tackle abuse and, therefore, is considered an unjustified breach of a fundamental freedom and, thus, an infringement of EU law.

Requiring VCRs in cases where only WAA can be tackled seems to clearly infringe EU law.

The use of this concept – VCR – besides not solving the problem of compatibility of the domestic CFC rules with EU law, gives rise to a new set of issues, which are more complicated than the issues that the amendment intended to resolve.

Take, for example, the following hypothetical situation: a resident decides to create a non-resident entity having a real establishment – with a significant physical presence that reflects economic reality – but only aimed at obtaining, in that other Member State, tax advantages (lower tax rate, better loss carry-forward of losses, etc.). Its constitution was purely tax driven. According to the ECJ decision in Cadbury Schweppes, this could trigger the application of CFC rules but the requalification still had to be withdrawn due to failing the proportionality test. Nonetheless, under the new article 66 of the Portuguese Corporate Income Tax Code (CITC), including the concept of VCR, the CFC regime should be applied since there are no VCRs, but purely fiscal motives behind the exercise of the freedom of establishment.

The conclusion is that, despite the changes made to the CFC regime in Portugal, it remains incompatible with EU law.

The best approach to amending the Portuguese CFC rule would be to develop a rule that shifts the burden of proof to the tax authorities in regard to satisfying the requirements that trigger the application of the CFC rule (and satisfying the burden of proof would also provide a justification for the restriction of a fundamental freedom), instead of asking the taxpayer to provide evidence that the situation at stake would not constitute a WAA, namely due to the level of establishment of the non-resident entity and other relevant objective factors taking into consideration its specific activity. The evidence that the requirements for the application of the CFC rule have been met can always be subject to review by the court.

4. The Passive Nature of the Income

What is also part of the bona fide exclusion, for intra-EU or EEA cases, is the requirement that the non-resident entity develop an activity of an active nature, or that does not generate passive income. This has to be shown in addition to the existence of VCRs.

This assumption goes far beyond a mere requirement to prove actual implantation and physical existence in terms of facilities, personnel and equipment and, therefore, does not comply with the proportionality analysis, as applied by the ECJ. Based on a reading of the TFEU and the ECJ’s case law it does not seem that the exercise of the freedom of establishment can be restricted, in general or in particular, to cases where the non-resident entity derives income from non-passive activities. And the same could be said in regard to all other freedoms, including the free movement of capital.

Furthermore, this assumption is redundant – and, therefore, unnecessary – taking into consideration the requirement enshrined in article 66(6)(a) of the CITC. According to this provision, the CFC rule does not apply when the non-resident entity obtains at least 75% of the income from an agricultural or industrial activity or from a commercial activity that does not involve residents in Portugal or at least that is mainly directed at the market where it is established. And the new bona fide provision for intra-EU or EEA CFC situations – article 66(12) – requires that the activities be fully active for the provision to apply.

Let us consider a scenario where a non-resident subsidiary based in a Member State obtains 75% of its income from an active activity and the remaining 25% from a passive activity. In this scenario, the CFC rule would already not be applicable due to the general exclusion to the exclusion provided by article 66(6)(a), and the second criterion of the bona fide clause of article 66(12) would become ineffective.

Finally, article 66(1) and (2) define control as the, direct or indirect, ownership of at least 25% of the shares of the non-resident company. This threshold drops to 10% if more than 50% of the shares are held by residents. The new threshold might create new problems in the area of the free movement of capital.

In general, and following, inter alia, Fidium Finanz (Case C-452/04), Elisa (Case C-451/05), A (Case C-101/05) and Scheunemann (Case C-31/11) in accordance with the principal aspect doctrine, cases falling simultaneously
under the freedom of establishment and the free movement of capital should only be resolved under the first, as the second is a necessary consequence of the exercise of the freedom of establishment. In this sense, cases involving third countries, where both freedoms could be equally invoked, fall outside the sphere of protection of EU law as the principal and overriding freedom is the freedom of establishment.

Traditionally, CFC rules require control and, therefore, raise issues only within the European Union, as the freedom of establishment is only protected in intra-EU and EEA scenarios. Nonetheless, domestic control is deemed to exist even in regard to a mere 10% holding and these cases will not likely qualify under the freedom of establishment, as it will be difficult to have definite influence with such a low participation. In all such situations, the acquisition of the participation amounts merely to the exercise of the free movement of capital, which is protected in inbound and outbound cases, and in intra-EU/EEA, as well as third-country scenarios.

In all these cases, the restriction on the free movement of capital has to be measured against the following two justifications: the fight against tax fraud and evasion and the effectiveness of fiscal supervision. But, in cases involving third countries, there is not even a bona fide provision and, therefore, it is highly doubtful that the court, if asked, would consider this blind, automatic and immediate imposition of the imputation (CFC rules) as compatible with EU law.³⁴

5. Conclusions

The Portuguese State Budget for 2012 introduced several amendments to the CFC rules, one of the most important of which is the bona fide clause regarding cases with EU and EEA states. In these scenarios, the rule is not applicable if the resident shareholder shows that there are VCRs for the establishment and operation of the subsidiary in a low-tax jurisdiction and that the entity’s activities are of an active nature.

Although these amendments are intended to make the domestic CFC rules compatible with EU law, they do not achieve that goal and introduce new compatibility problems.

The VCR concept is a harmonized direct taxation concept that stems from the Merger Directive (2009/133) and, as the ECJ ruled in Foggia, it involves more than the demonstration of the existence of pure tax motives.

The ECJ’s benchmark in regard to abuse in respect of non-harmonized direct taxation is based on the WAA concept, which entails a significantly lower standard in terms of protection. Under the latter, the exercise of a fundamental freedom can be driven merely by tax reasons as long as there is a genuine or effective exercise of such a freedom. In terms of establishment, only letterbox companies or other entity forms that are not intended to carry on a genuine activity in the host Member State can be targeted as abusive.

The difference between these two concepts is substantial and cannot be resolved merely by interpretation. The introduction of a bona fide clause based on the demonstration of VCRs does not resolve the compatibility problem of the Portuguese CFC rules with EU law, as they will still be considered as going beyond what is necessary to prevent abuse. Moreover, the low threshold of participation, in certain cases, might trigger the protection granted by the free movement of capital, with the result that Treaty protection will even apply in cases involving third countries.

³⁴ I.e., the “external” dimension of the free movement of capital and payments, which applies not only in cases involving EU countries, but also to third countries, particularly with regard to countries on the blacklist. For instance, this would be the case where a resident entity holds 10% of a non-resident company established in a blacklisted jurisdiction (with which Portugal has a TIEA), which is more than 50% held by Portuguese residents. In this case, the CFC rule would be automatically applied without any bona fide clause, which could be seen as an unjustified or disproportional restriction on the free movement of capital and payments.