JUDGMENT OF THE COURT (First Chamber)

17 June 2010 (*)

(Failure of a Member State to fulfil obligations – Freedom to provide services and free movement of capital – Articles 49 EC and 56 EC and Articles 36 and 40 of the EEA Agreement – Direct taxation – Taxation of interest received – Discriminatory treatment of non-residents – Burden of proof)

In Case C-105/08,

ACTION under Article 226 EC for failure to fulfil obligations, brought on 6 March 2008,

European Commission, represented by R. Lyal and M. Afonso, acting as Agents, with an address for service in Luxembourg,

applicant,

v

Portuguese Republic, represented by L. Inez Fernandes, J. Menezes Leitão and C. Guerra Santos, acting as Agents,

defendant,

supported by:

Republic of Lithuania, represented by D. Kriaučiūnas and V. Kazlauskaitė-Švenčionienė, acting as Agents,

intervener,

THE COURT (First Chamber),

composed of A. Tizzano, President of the Chamber, A. Borg Barthet, M. Ilešič, J.-J. Kasel (Rapporteur) and M. Berger, Judges,

Advocate General: J. Kokott,

Registrar: M. Ferreira, Principal Administrator,

having regard to the written procedure and further to the hearing on 11 February 2010,

after hearing the Opinion of the Advocate General at the sitting on 25 March 2010,

gives the following

Judgment

1 By its application, the Commission of the European Communities seeks a declaration from the Court that, by taxing the interest paid to non-resident financial institutions more heavily than the interest paid to financial institutions resident in Portuguese territory, the Portuguese Republic restricts the freedom of financial institutions resident in other Member States, and in States party to

the Agreement on the European Economic Area of 2 May 1992 (OJ 1994 L 1, p. 3; 'the EEA Agreement'), to provide mortgage and other loan services, and it has therefore failed to fulfil its obligations under Articles 49 EC and 56 EC and Articles 36 and 40 of the EEA Agreement.

Legal context

2 Under Article 4(2) of the Portuguese Corporation Tax Code (Código do Imposto sobre o Rendimento das Pessoas Colectivas, 'the CIRC'), implemented by Decree-Law No 442/B/88 of 30 November 1988, as amended by Decree-Law No 211/2005 of 7 December 2005 (*Diário da República* I, Series A, No 234 of 7 December 2005), legal persons and other legal entities not having their seat or place of actual management within Portuguese territory are subject to corporation tax ('IRC') only in respect of income acquired in Portugal. Under Article 4(3)(c) of the CIRC, such income includes interest paid by debtors resident, or having their seat or place of actual management, within Portuguese territory, or the payment of which is attributable to a permanent establishment in that State.

3 In the absence of a convention for the avoidance of double taxation ('DTC'), under Article 80(2)(c) of the CIRC such income is as a rule taxed at a rate of 20%.

4 Under Article 88(1)(c),(3)(b) and (5) of the CIRC, the IRC in question is to be levied at source as definitive tax.

5 The DTCs concluded between the Portuguese Republic and the other Member States of the European Union and the States party to the EEA Agreement provide, in accordance with Article 11 of the Model Tax Convention on Income and on Capital drawn up by the Organisation for Economic Cooperation and Development (OECD), that the rate applied to the income in question by the source State is to be between 10% and 15%. Under Article 90-A(1) of the CIRC, in such cases the obligation to withhold tax at source is limited to the corresponding IRC. In the case of the two States with which the Portuguese Republic has not concluded a DTC, that is to say, the Republic of Cyprus and the Principality of Liechtenstein, that rate rises to 20%.

6 The parties to the proceedings agree that the taxation of income from interest acquired by non-resident financial institutions is levied on the gross amount of income, whereas the income from interest received by resident financial institutions is included within their taxable profit. When that profit is being calculated, costs incurred are deducted. In accordance with Article 80(1) of the CIRC, taxation is levied on that profit at the general rate of 25%. The Portuguese Government takes the view that, in the second case, tax may be regarded as being levied on the net amount of interest, which may, in particular, correspond to the difference between the interest received and the interest paid to third parties in order to obtain the capital necessary to complete the credit transaction.

Pre-litigation procedure and the proceedings before the Court

7 On 21 March 2005, the Commission sent a letter of formal notice to the Portuguese Republic, drawing the attention of the Portuguese authorities to the fact that, by taxing the mortgage interest received by non-resident financial institutions more heavily than that received by resident financial institutions, the Portuguese Republic restricts the provision of mortgage and other loan services by foreign financial institutions, and in so doing fails to fulfil its obligations under Articles 49 EC and 56 EC and Articles 36 and 40 of the EEA Agreement.

8 Since the reply of the Portuguese Republic did not satisfy the Commission, on 19 December 2005 the Commission sent a reasoned opinion to that Member State, calling upon it to adopt the measures necessary to achieve compliance within two months of receipt.

9 On 24 February 2006, the Portuguese Republic replied that it maintained its view that the CIRC is

consistent with Community law and is, in any event, justified on the grounds of the coherence and internal logic of the national tax system. In addition, the solution advocated by the Commission would, it claimed, involve disclosure by the non-resident financial institutions of the information necessary to determine their net income. However, the monitoring of that information would cause obvious difficulties for the Portuguese tax authorities.

10 Since the Commission was not satisfied with the Portuguese Republic's reply, it decided to bring the present action.

11 By order of the President of the Court of 4 August 2008, the Republic of Lithuania was granted leave to intervene in support of the form of order sought by the Portuguese Republic.

The action

Arguments of the parties

12 The Commission submits that, even though the rate of taxation applicable to the income of non-resident financial institutions is lower than that levied on the similar income of resident financial institutions, the tax burden borne by the former in Portugal is, in fact, significantly higher, since, unlike resident legal entities, non-resident legal entities cannot deduct from the amount of taxed income the operating costs directly connected with the activity pursued. As is apparent from Case C-443/06 *Hollmann* [2007] ECR I-8491, paragraphs 35 to 38, such a difference in treatment amounts to discrimination against non-resident financial institutions.

13 By providing for a withholding tax of between 10% and 20% on the gross amount of interest obtained in Portugal, the legislation at issue discourages any foreign credit institution from offering its services in Portugal unless its profit margin for the transactions concerned is significantly higher than the rate of withholding tax. However, in the light of the extremely competitive nature of the international financial markets, of the context created by the existence of a common currency in the euro zone, and of the similar levels of interest rates in most Member States, it is very unlikely that a foreign financial institution would be able to achieve a profit margin greater than 10%. Furthermore, in order to restore equality with resident financial institutions, which are taxed at 25% on their net income, non-resident financial institutions would have to achieve profit margins four times higher than those obtained by resident financial institutions in their respective activities pursued in Portugal.

14 The Commission submits that, in the present case, it cannot reasonably be maintained that resident and non-resident financial institutions are not in an objectively comparable situation. It follows from the Court's case-law, and in particular from Case C-234/01 *Gerritse* [2003] ECR I-5933, paragraph 27, and Case C-345/04 *Centro Equestre da Lezíria Grande* [2007] ECR I-1425, paragraph 24, that, with regard to operating expenses which have a direct connection to the activity, pursued by a non-resident in a Member State, which generated taxable income in that country, residents and non-residents are placed in a comparable situation. Accordingly, those expenses must, as a rule, be taken into account in that country since residents are taxed there on their net income, that is, after the deduction of such expenses. According to the judgment in *Hollmann* (paragraphs 50 and 51), the principle of non-discrimination requires, moreover, that, where the same tax is applied to residents and non-residents, the income of non-residents should not be taxed at a higher rate than that applied to residents' income and that the tax base should not be broader than that provided for residents. Non-resident financial institutions should therefore, at the very least, be allowed to deduct the amount of the interest which they have had to pay to third parties in order to obtain the capital used in the credit transactions completed in Portugal.

15 The Commission also submits that, contrary to the Portuguese Republic's contention, it is not for the State of residence to set, by means of conventions or unilateral measures for the avoidance of

double taxation, the tax burden which will ultimately be borne by the investor. On the contrary, the onus is on the Member State which has discriminatory legislation to remove that discrimination. In the present case, the Portuguese Republic's argument is, moreover, irrelevant since the level of withholding tax applied by that Member State is so high that it is likely to absorb the entire profit from a credit transaction completed under normal market conditions.

16 Lastly, as regards the argument that the difference in treatment at issue in the present case is justified by overriding reasons in the public interest, that is to say, both the safeguarding of the allocation of taxation powers between the Member States and the prevention of tax avoidance, the Commission maintains, inter alia, that there are other measures, in particular those laid down by Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (OJ 1977 L 336, p. 15), which enable the Member States to achieve the objectives of those overriding reasons in the public interest, while having regard to the principle of proportionality.

17 In its reply, the Commission makes clear that the alleged failure to fulfil obligations consists not in the actual existence of situations such as that put forward by way of example in the context of the present proceedings, but in the maintenance in force of national provisions the application of which leads to an obvious difference in tax treatment between resident and non-resident financial institutions to the detriment of the latter.

18 The Commission acknowledges that it is not possible to ascertain which capital obtained from third parties has been used specifically by a legal entity in order to finance individual credit transactions completed in a given State. It submits, however, that it is not impossible to calculate the amounts of net income obtained by that entity for the purposes of taxation in the source State. In the present case, the Portuguese Republic would simply need to allow the taxpayer to deduct from the amount of gross income obtained within the territory of that Member State an amount corresponding to the average costs which are generally borne by that taxpayer in order to obtain similar income in the State of residence. In order to prevent non-resident financial institutions from deducting average costs which might be regarded as excessive by the source Member State, that latter State could limit the deduction of costs to a maximum amount fixed, for example, on the basis of the average costs borne by resident banks for similar transactions. In any event, the difficulty of attributing particular costs to certain specific income does not constitute valid justification for taxing the gross income of non-residents in the source State or for applying to such income an actual tax burden which is higher than that levied on the similar income received by resident taxpayers.

19 The Portuguese Republic submits that the discriminatory treatment alleged by the Commission is based on a mere presumption. Since the Commission has not proved the alleged failure to fulfil obligations, its action should be dismissed.

20 That Member State contends that, even if it were to be assumed that there are cases in which, in the light of the specific circumstances of the financial transaction, a difference in tax burden may be observed in the taxation of interest obtained by resident and by non-resident financial institutions, that difference in treatment is not discriminatory and does not entail any restriction of the freedoms referred to in Articles 49 EC and 56 EC and Articles 36 and 40 of the EEA Agreement.

21 The situations of resident and non-resident financial institutions are not, it submits, objectively comparable, with the result that the existence of a difference in treatment relating to the tax base for interest received within Portuguese territory is justified. That difference stems from the specific nature of financial transactions and the provision of services for the grant of credit, and is connected to the fact that it is not generally possible to establish a characteristic link between the costs borne and the income obtained, or, for each transaction, to relate the profit obtained to the funds used for financing. Thus, the interest received by non-resident financial institutions must be taxed on a gross basis, whereas the income of resident financial institutions is taxed on a net basis. To the extent to which, in the case of resident financial institutions, their total income is taken into consideration,

irrespective of the place where that income was acquired, it is also possible to take into account the total costs borne.

22 The Portuguese Republic also submits that, in any event, the legislation at issue must be regarded as being justified by overriding reasons in the public interest. In that connection, it invokes the safeguarding of the allocation of taxation powers, in accordance with the principle of the territorial application of tax, and the combating of tax avoidance.

23 In its rejoinder, the Portuguese Republic also submits, inter alia, that since the Commission acknowledges that it is not possible to ascertain which capital has been used specifically by a legal entity in order to finance credit transactions completed in a given Member State, the 'legal construct' on which the Commission's argument is based goes beyond the limits permitted under Community law. The legislation at issue cannot therefore, it is argued, be regarded as incompatible with the EC Treaty or the EEA Agreement.

24 The system advocated by the Commission amounts to applying an abstract and artificial deduction to the income of non-resident financial institutions, which means that the result of the operation would bear no relation to the actual position of the net income of non-resident operators. Indeed, in such a system, contrary to the requirements of the case-law cited in that regard by the Commission, there is no connection between the expenses taken into account and the activity which generated the taxable income. It follows that, in the light of the legislation at issue in the present case, resident and non-resident legal entities are not in an objectively comparable situation.

25 The Republic of Lithuania, intervening in support of the Portuguese Republic, submits that, in order to be able to determine whether there is a difference in treatment which operates to the detriment of non-resident financial institutions, account should be taken not only of the taxation levied in the source State but also of that which is applied in the State of residence of the legal entities in question. In the present case, however, the Commission confines itself to examining the treatment arising from the application of the Portuguese legislation and disregards the effects produced by the legislation of the State of residence of those legal entities not resident in Portugal on their capacity and willingness to offer their services within Portuguese territory. The inevitable conclusion therefore is that the Commission has not proved the alleged failure to fulfil obligations.

Findings of the Court

26 From the outset, it should be borne in mind that, according to settled case-law, in proceedings brought under Article 226 EC for failure to fulfil obligations, it is incumbent upon the Commission to prove the allegation that an obligation has not been fulfilled. It is the Commission's responsibility to place before the Court the information required to enable the Court to establish that the obligation has not been fulfilled, and in so doing the Commission may not rely on any presumption (see, inter alia, Case 290/87 *Commission* v *Netherlands* [1989] ECR 3083, paragraphs 11 and 12, and Case C-241/08 *Commission* v *France* [2010] ECR I-0000, paragraph 22).

27 In the present case, in order to prove that the Portuguese legislation, which, it is not disputed, treats resident and non-resident legal entities differently with regard to IRC, results in higher taxation of non-resident legal entities, the Commission relies on an arithmetical example based on the assumption that the profit margin achieved by the entity in question in that example is 10%.

28 However, as is apparent from the table produced by the Advocate General at point 31 of her Opinion, and for the reasons developed more fully at points 37 to 39 thereof, that profit margin plays a decisive role in the examination of whether legislation such as that at issue in the present case leads to higher taxation of non-resident legal entities, as the rate of taxation is not the only component to be taken into consideration in that regard.

29 In so far as the calculation in question, which the Commission itself describes as 'theoretical', is

disputed by the Portuguese Government on the ground that the premiss underlying it bears no relation to the true position, and since that government puts forward a calculation based on a different profit margin which produces a solution in which resident legal entities are taxed more heavily, the onus was on the Commission, as the Advocate General observed at point 40 of her Opinion, to establish that the figures on which its calculation is based reflect the economic reality. Thus, the Commission could have furnished, inter alia, statistical data or information concerning the level of interest paid on bank loans and relating to the refinancing conditions in order to support the plausibility of its calculations.

30 It is, however, clear that, in the present case, the Commission failed to produce, either during the written procedure or the hearing, and not even after an express request by the Court, any conclusive evidence whatever which would have been capable of establishing that the figures which it puts forward in support of its argument are in fact borne out by the actual facts and that the arithmetical example on which it relies is not purely hypothetical.

31 Accordingly, it must be held that, in the present case, the Commission has not proved the alleged failure of the Portuguese Republic to fulfil its obligations.

32 The Commission's action must for that reason be dismissed.

Costs

33 Under Article 69(2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. Since the Portuguese Republic has applied for costs to be awarded against the Commission and the latter has been unsuccessful, the Commission must be ordered to pay the costs. The Republic of Lithuania, which intervened in support of the form of order sought by the Portuguese Republic, must bear its own costs, in accordance with the first subparagraph of Article 69(4) of the Rules of Procedure.

On those grounds, the Court (First Chamber) hereby:

1. **Dismisses the action;**

2. **Orders the European Commission to pay the costs;**

3. **Orders the Republic of Lithuania to bear its own costs.**

[Signatures]

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* Language of the case: Portuguese.