# Tax harmonization *versus* tax competition: a view from the periphery

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Portuguese foreign fiscal policy has gone through various different phases. Even if there was no set purpose in the existence of such various phases, such existence may be detected in the positions expressed by Portugal both in the European Community and in the OECD. We shall seek to synthesize such various phases and the reasons behind them.

A política fiscal portuguesa atravessou diversas fases. Mesmo não tendo a existência destas fases correspondido a um objectivo pré-determinado, podem ser identificadas nas posições portuguesas assumidas na Comunidade Europeia e na OCDE. São essas fases e as suas razões que procuremos identificar de forma sintética.



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## *1. The revenue safeguarding phase*

In the negotiation of the double taxation treaties which Portugal has entered into since the 60s (when the Portuguese economy opened up to the exterior), there were two main aspects to its external fiscal policy.

The first was to attract foreign capital by means of a low taxation and a policy of fiscal/ bank secrecy. This goal led to the formulation of a reserve in the Commentary to the "Model Tax Convention" regarding the exchange of information, such reserve having determined a policy which made it difficult to enter into some treaties[2].

The second – which was also an obstacle to the entering into of treaties – was the position of less developed countries concerning the scope of the concept of *permanent establishment* (having made reserves to article 5 of the referred Model Tax Convention)[3] and concerning the taxation of dividends, interest and royalties, where the principle of source state taxation was reaffirmed.

Portugal assumed therefore the characteristics of a near tax haven, but in a manner which was not very coherent. Even if a strict bank secrecy system would prevent the providing of information on deposits to non-residents, such deposits were taxed in Portugal, which made it impossible for such bank secrecy to attract capital.

However, the policy of maintaining fiscal and bank secrecy was only abandoned at the time of the negotiation of the Savings Directive[4], which was partially concluded during the second Portuguese presidency of the European Union. The much too broad

[2] M. MARGARIDA MESQUITA, *As Convenções sobre Dupla Tributação* (Lisboa: 1998), 48-49 and 343, criticizing this measure being maintained.
[3] On the manner in which such concept was dealt with in Portuguese tax legislation, see MANUELA DURO TEIXEIRA, *A Determinação do Lucro Tributável do Estabelecimento Estável de Não Residentes* (Coimbra: 2007), 22-27.
[4] Council Directive 2003/48/EC, of 3 June 2003, on the taxation of savings income in the form of interest payments, transposed to the national legislation by Decree-Law no. 62/2005, of 11th March.

conception of *permanent establishment* disappeared from internal Portuguese legislation following a revision of the then current policy.

As regards the provisions intended to attract revenue, it took quite some effort to have Portugal surrender to the home state taxation principle adopted by the "parent companies, controlled companies" Directive[5] (Portugal having managed to postpone its application) and it resisted the Directive on interest and royalties[6] for as long as it was able to. In this phase, however, its resistance was only to the loss of revenue, as there was already an openness as regards European tax harmonization.

## *2. The holdings from Madeira and Portuguese fiscal policy*

As a distorting factor of Portuguese foreign tax policy there is the creation of the "Madeira Offshore", which was clearly a regional imposition to central power, explicable only by Madeira's electoral importance in Portuguese political life.

The "Madeira Offshore" started off as an industrial area, but with no success. The companies comprised in such offshore either existed only for as long as they would receive subsidies or were companies already in the region prior to the creation of the new system of taxation (beer producers, concrete).

The negotiation with Brussels of permission for the Madeira Offshore to move to the financial area represented therefore a mad headlong flight. Instead of industries, Madeira would now attract holdings, which would benefit from a tax exemption as regards revenues obtained in any location other than continental Portugal.

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

[6] Council Directive 2003/49/EC, of 3 June 2003, on a common system of taxation applicable to interest and royalty payments between associated companies of different Member States.

Located in the Portuguese territory, the "Madeira Offshore" could thus benefit from the set of double taxation conventions entered into by Portugal - of course, while such conventions were not denounced, as was the case with Brazil and Denmark, and provided the wording of the convention did not preclude its application, as happened at first with the agreements entered into following the creation of the Offshore[7].

The aims of the amendments to the system were not, however, achieved. The regulation of the Offshore was a result of the pressure exerted by the Madeira Regional Government on the Ministry of Finance which led to such regulation not having been carried out so as to maximize the advantages to Madeira of creating such tax privilege system. For example, it is not demanded that the companies located in the "Madeira Offshore" have a permanent physical corpus in the Region.

Furthermore, the "Madeira Offshore" was a very poor instrument for the tax competition it was intended to achieve. This was due to having come into existence after many other financial centres and to its unfavourable geographic location.

The main advantages ended up being to the benefit of Portuguese banking institutions. For a long while, the companies located in Madeira benefited from an administrative understanding which allowed significant fiscal benefits from the simple formal displacement of financial flows to the Region. When such understanding changed, the companies were shut down.

It should be noted, however, that the existence of the "Madeira Offshore" created a tendency towards tax competition in Portuguese fiscal policy. It was the European Commission that, from the year of 2000, limited the establishing of new companies in Madeira. At present, however, the joint influence of the need to increase public revenue

[7] On its functioning, see RICARDO BORGES, *A Zona Franca da Madeira entre a Isenção e a Elisão: um Contributo para o Estudo do Direito Tributário Internacional Português*, Biblioteca da FDUL, T – 3435. ALBERTO XAVIER, *Direito Tributário Internacional*[2] (Coimbra: 2007), 563 ff.

and the taxation of the banking sector, and Madeira's loss of political influence resulted in this region being less important than it once was as regards Portuguese foreign fiscal policy.

### *3. The ECJ and the specific anti-avoidance provisions*

Up until now, the decisions of the European Court of Justice only touched minor (or clearly archaic) issues concerning the Portuguese fiscal system.

The *MODELO, SGPS, SA*[8], *MODELO CONTINENTE, SGPS, SA*[9] and *SONAE*[10] cases brought about the need to rationalise the financing system of registries and notary offices, by preventing the excessive burdening of the capital markets. The *EPSON*[11] case did away with a tax on company dividends of minor financial significance to the Budget. The recent *Hollmann*[12] case prevented a discriminatory provision as regards the reinvestment of capital gains.

In all these cases, the decisions of the ECJ did not question any defence mechanism of the Portuguese fiscal system. Decisions such as the one in the *Lasteyrie du Saillant*[13] case are also unlikely to have any consequences in Portugal due to the

[8] ECJ Decision of 29 September 1999, P. C-56/98 – MODELO SGPS SA vs. Director-Geral dos Registos e Notariado, on notary fees demanded for a public deed concerning a share capital increase and an amendment of the by-laws of a public limited company.
[9] ECJ Decision of 21 September 2000, P. C-19/99 – MODELO CONTINENTE SGPS SA vs. Fazenda Pública.
[10] ECJ Decision of 21 June 2001, P. C – 206/99 – SONAE – TECNOLOGIA DE INFORMAÇÃO SA vs Direcção-Geral dos Registos e Notariado.
[11] ECJ Decision of 8 June 2000, P. C – 375/98 – Ministério Público e Fazenda Pública vs. EPSON EUROPE BV.
[12] ECJ Decision of 11 October 2007, P. C-443/06 – Erika Waltraud Ilse Hollmann vs. Fazenda Pública.
[13] ECJ Decision of 11 March 2004, P. C- 9/02 - Hughes de Lasteyrie du Saillant vs. Ministère de l'Économie, des Finances et de l'Industrie.

minor significance of the taxation of capital gains of individuals. However, the Portuguese fiscal system, as the remaining European systems that do not want or that cannot opt for tax competition and for the race to the bottom, is also under threat by decisions such as the *CADBURY SCHWEPPES*[14] decision. In this case, it is not a specific Portuguese problem but the more general matter of knowing what the reply will be to the question asked a few years back: "*Is tax fairness in Europe under siege*?"[15].

If tax competition regarding company tax rates continues and the principle of freedom of establishment is interpreted in accordance with the *CADBURY SCHWEPPES* case, we shall end up with fiscal systems in which, basically, only consumption and income from work are taxed. It will be impossible to tax both capital gains and companies.

Tax harmonization should, therefore, include the common tax base, but also the minimum rate. Without the minimum rate, the only point of balance between the various European rates shall be the zero rate.

Also, Portugal shall end up having the same difficulty in keeping its numerous specific anti-avoidance provisions, since the ECJ has reaffirmed its hostility as regards the provisions of automatic application which do not imply the need for the Tax Administration to prove that there was an avoidance purpose on the part of the tax payer. It did so, for example, in the *Lasteyrie du Saillante*[16] case and even in the *CADBURY SCHWEPPES* case, subjecting the application of the CFC rules to the

[14] ECJ Decision of 12 September 2006, P. C – 196/04 - CADBURY SCHWEPPES PLC e CADBURY SCHWEPPES OVERSEAS LTD vs. Commissioners of Inland Revenue.
[15] CRISTINA GARCIA-HERRERA / PEDRO M. HERRERA, "Is tax fairness in Europe under siege? Spanish law and anti-avoidance provisions", EC Tax Review, Vol. 13 (2) (2004), 57- 64.
[16] ECJ Decision of 11 March 2004, P. C- 9/02 - Hughes de Lasteyrie du Saillant vs. Ministère de l'Économie, des Finances et de l'Industrie.

demonstration of the artificial nature of the company located in the low taxation area, which radically alters the manner in which these rules are usually applied[17].

There may even be a change in attitude by some Member States regarding the CFCs. Instead of rules intended to avoid company groups from placing their profit in low taxation areas, we might start having rules intended to devoid such financial companies of their artificial nature. The States shall compete among themselves to be chosen as the country for such companies' registered offices.

The *COLUMBUS CONTAINER SERVICES BVBA & CO.*[18] case is yet another case where the ECJ will have to decide whether a measure unilaterally taken by a country to neutralize structures intended to encourage harmful tax competition are compatible with European Law. It should be stressed, however, that if unilateral measures exist that is because tax competition is possible and because there is no agreement on multilateral measures.

## *4. The dual income tax: from the taxation of capital to the optimization of capital flows*

Portuguese fiscal doctrine has found support up until now in German doctrine to defend a tax system having as its guiding light the ability to pay principle, which entails a taxation at least equivalent between revenue from work and revenue from capital. The creation of a dual income tax system, as was started in Scandinavia and Austria, initially seemed a mere reaction to moderate the previous excesses in taxation, considering the indisputable fact of the mobility of capital as a production factor.

[17] STEFAN WALDENS, „Steuern steuern durch Prinzipalstrukturen: Ist nach Cadbury Schweppes nunmehr fast alles möglich?" IStR 13 (2007). Defending, prior to this decision, the compatibility of CFC with EC Law, W. SCHOEN, "CFC Legislation and European Community Law", BTR, 4 (2001), 250.
[18] C – 298/05. Conclusions of Attorney General PAOLO MENGOTTI.

However, the stand taken at present by German doctrine with the new dualism in the taxation of income seems to reflect to a great extent the victory of competition over harmonization[19], since the inevitability of taxing capital more favourably than work is accepted based on the argument that this kind of taxation will favour a more efficient allocation of capital[20].

The existence of an agreement at the European level on the minimum taxation level of companies would probably allow an equal taxation of capital and work to be maintained. The differencing would result from the level of income (with its inevitable consequences on the ability to pay) and not from the nature of the income.

## *5. A Common Consolidated Corporate Tax Base (CCCTB)*

Contrary to what happens with the discussion on the minimum rate of the corporate tax in Europe, the common tax base already has a well-established starting point: the adoption of the IFRS/IAS. The determination of the taxable profit based on the corrections to the tax balance sheet is the rule in continental Europe and, thus, the common rules on financial information are the starting point for the establishment of rules on the definition of taxable profit – with all that this might entail as regards simplification.

[19] W. SCHÖN, „Der Dualismus der Einkunftsarmen im geltenden Recht“ , DstJG v 30 (2007), 28.
[20] MORIS LEHNER, „Die Reform der Kapitaleinkommensbesteuerung im Rahmen des Verfassungs-und Europarechts“, DstJG, 30 (2007), 66.

Now, as is stated in the 2006[21] document, the Commission does not intend to include the question of the rate in the discussion on the base. Thus, even though, as we all know, the quantification of the taxable profit can be affected both by the decisions on the base and by the decision on the rate, the existence of common rules on the base will not prevent the tax burden from differing from country to country. The tax rate is left out of the agreement – tax competition will continue to exist.

It is, in fact, likely that it even increases with the continuous arrival of new countries. As is shown in a KPMG survey, there is widespread support across Europe to the simplification of rules, but not on quantification, which justifies the Commission's caution. A more useful discussion thus lies in the relation between the financial information rules and the provisions for the determination of the tax base, and some fundamental principles must be defined as regards this matter.

The Commission's last information[22] seems to accept that the financial information rules are not directly transposable to the tax balance sheet. It will be necessary to create specific rules for the tax balance sheet containing definitions based on national accountancy and national rules for determining the tax base.

However, there is a difficulty here: the creation of specific rules and definitions for the determination of the deductible costs. For example, specific rules concerning provisions.

Essentially, this corresponds to the problems of the Tax Administrations, who are always worried with the decrease in revenue and fearful that the much too broad referral to the IFRS/IAS might be a way to undermine their authority.

[21] Commission Communication no. 157/2006.
[22] Commission Communication no. 157/2006, 13.

However, the rule of the predominance of the commercial balance sheet, even if it is just the continental system and not the system of the whole European Union[23], is probably the only way of unifying the principles of company taxation in Europe.

The divergences and derogations allowed based on the practicability principle and on the need for fiscal control should therefore be as scarce as possible. This, in spite of the pressure to the contrary which will inevitably be exerted by the Tax Administrations. Unless that faced with the risk of having their decisions questioned by the ECJ they accept as a lesser evil the creation of a common base for the taxation of companies.

[23] The degree of divergence between the two in the United Kingdom can be seen in CHRISTIAN KERSTING, „Das Verhältnisse zwischen handelsrechtlicher and steuerrechtlicher Rechnungslegung in Grossbritanien", im W. SCHÖN, *Steuerliche Massgeblichkeit in Deutschland und Europa* (Colónia: 2005), 305 ff.