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Withholding Tax Contrary to EU Law: The *Brisal* Case

On 13 July, the Court of Justice of the European Union (CJEU) released its decision in the *Brisal* case (C-18/15). The *Brisal* case has potentially far reaching implications for European Union (EU) businesses that either currently suffer or have previously suffered withholding tax (WHT) within the EU.

Background: How EU Law Can Impact the Tax Rules of Member States

The Treaty on the Functioning of the European Union (the TFEU, formerly known as the EC Treaty) provides for certain fundamental freedoms to be enjoyed by nationals of Member States: free movement of workers (Article 45), freedom of establishment (Article 49), freedom to provide services in another Member State (Article 56) and free movement of capital (Article 63).

Where national tax laws infringe the fundamental freedoms enshrined in the TFEU and those tax laws operate in a discriminatory manner (treating tax residents more favourably than non-residents), those laws can be regarded as being incompatible with the TFEU unless they can be objectively justified. Over recent years, the CJEU has ruled on the circumstances in which such discrimination is regarded as unjustifiable and therefore contrary to EU law. If the CJEU delivers a judgment that the tax laws of a Member State are incompatible with the TFEU, this can have an immediate effect on other Member States with similar or equivalent tax laws. Firstly, those Member States may need to amend their laws in order to ensure compatibility with the TFEU. Secondly, businesses can seek to recover overpaid tax from the tax authorities of the relevant Member States (subject to rules on limitations of claims). Both of these consequences may flow from the *Brisal* case. As explained in this advisory, the case could have far reaching implications in relation to EU source WHT, well beyond its own facts.

How Does WHT Arise in the EU?

EU Member States have been able to prescribe the scope of WHT and the prevailing rates of WHT that apply to income streams (interest, dividends, royalties and rental income) deriving from sources within their own jurisdiction. This WHT has been subject to any exemptions provided for under domestic laws of Member States (for example, exemptions for interest paid to certain types of lending institutions), as well as any relief under an applicable double tax treaty between the payer's jurisdiction and the income owner's jurisdiction or, if the income owner is based in another Member State, subject to the effect of the EU Parent-Subsidiary Directive or the EU Interest and Royalties Directive.

Whilst it is possible that WHT may in some way be harmonised by future EU tax initiatives, this is not imminent. A discussion of potential future EU tax initiatives, such as the Common Consolidated Corporate Tax Base, are beyond the scope of this advisory.

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Brisal

On its facts, the case concerned the question of whether Portuguese rules that impose WHT at the rate of 20 percent on interest payments made by a Portuguese tax resident company to a non-resident were contrary to the TFEU. The WHT is applied on a *gross basis* (i.e., without any deduction for costs and expenses). In the case, KBC Finance Ireland suffered WHT on the interest it received from the Brisal, its Portuguese borrower at the rate of 15 percent (as reduced under the Portugal-Ireland double tax treaty). KBC argued that the WHT rules had unjustifiably infringed the freedom to provide services because a Portuguese lender would be taxed at 25 percent on a *net basis* (i.e., after deduction of related business expenses, such as its financing costs in relation to the loan).

The CJEU decided that the application of WHT to non-residents in circumstances where residents were not subjected to the same WHT was justifiable on overriding grounds of general interest but it was not justifiable for non-resident lender to face WHT on a *gross basis* whilst taxable profits of resident lenders were calculated on a *net basis*. Accordingly, the Court found that the net basis should apply to calculating the WHT and that expenses of non-resident lenders should be deductible if they are "directly related" to the lending. Whilst the scope of deductible items would need to be determined under national law, the Court stated that deductible expenses could include financing costs, legal and tax advice and (surprisingly) even a proportion of general overheads which are necessary for granting of the particular loan.

Impact of *Brisal*: What Should EU Lenders Do?

The consequence of *Brisal* is that the tax basis for WHT on interest paid to EU lenders should be limited to no more than the spread between the interest received by the EU lender and the lender's own finance costs. Many Member States have developed WHT exemptions for financial institutions, but this has not provided universal coverage. In this regard, it also should be noted that *Brisal* should be capable of being applied to a broad range of lending entities, rather than being restricted to a narrow class of financial institution. Therefore, lending businesses should consider whether they have any potential claims to recover overpaid WHT and, if so, whether they should file protective claims in respect of recovery of that WHT.

Beyond *Brisal*: Impact on Other Types of Cross-Border Income?

Whilst it will take time for the impact of *Brisal* to be assessed, it is an intriguing question as to whether any of the reasoning or the decision itself could be relevant to the determination of WHT on other types of EU source income streams, such as WHT on dividends, royalties or rent. If *Brisal* extends to such income and those equivalent WHT rules unjustifiably infringe the TFEU freedoms, relevant Member States may need to change their WHT rules and it may also be open to EU businesses involved in the development/licensing of intellectual property or land to recover overpaid WHT.

Brexit May Limit *Brisal* in the UK

As discussed in the recent advisory, "What Does Brexit Mean for UK Tax?", the implementation of Brexit is likely to affect the UK's recognition of the fundamental freedoms protected by the TFEU and any related judicial decisions of the CJEU. Accordingly, whilst *Brisal* and any subsequent CJEU decisions continue to apply to income paid to or from the UK, businesses should be aware that Brexit may limit their ability to recover overpaid WHT, especially if claims are delayed until after full Brexit implementation.

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