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The CJEU judgment in Brisal – withholding tax on interest held to be contrary to EU law

The Court of Justice of the European Union (CJEU) yesterday ruled that the EU fundamental freedoms preclude Member States from imposing withholding tax on interest paid to EU financial institutions, unless the financial institutions can claim a deduction for their financing costs and other expenses.

This note summarises the CJEU's decision and looks at the implications of the case, which we believe go considerably beyond its own facts. There may, in particular, now be opportunities for some taxpayers to recover withholding tax historically paid, and for taxpayers to contest the application of withholding tax on future payments.

What is the current position for withholding tax payments on intra-EU interest?

Interest withholding tax was in the past a significant barrier to cross-border financings within the EU. There has, however, been a long term trend for Member States to either abolish withholding taxes or enact flexible exemptions.

There are only two EU Member States, Portugal and Greece, that generally impose withholding tax on payments to EU financial institutions (with very limited exceptions in double tax treaties).

There are several further Member States where withholding taxes are imposed in certain cases where tax treaties do not provide complete exemptions. So, for example, the UK imposes withholding tax on interest paid to Italian and Portuguese financial institutions, and Croatia, Slovenia and Lithuania are in a similar position.

Italy generally imposes withholding tax (with limited treaty relief) but in 2014 enacted an exemption for interest paid to EU financial institutions (subject to certain conditions).

Brisal

The decision in *Brisal* looks set to change the withholding tax position across those Member States that still impose it, and create the opportunity for historic withholding tax to be refunded.

The case concerned interest payments by the Portuguese company, Brisal – Auto Estradas do Litoral S.A., on a straightforward commercial loan advanced by an Irish bank, KBC Finance Ireland. Brisal was required to withhold Portuguese tax at a rate of 15 per cent on the gross amount of its interest payments (as per the Ireland-Portugal tax treaty). By contrast, a Portuguese lender would have been required to pay Portuguese corporate income tax of 25 per cent on its net (rather than gross) profit.

Brisal and KBC Finance submitted that taxing residents on their net profit, but non-residents on their gross profit, was discriminatory against non-resident financial institutions and was in breach of the freedom of services principle under EU law.

To determine whether or not Brisal's and KBC Finance's assertion was correct, the CJEU considered two main questions; first, whether the

imposition of withholding tax per se infringed the freedom to provide services; and, second, whether the calculation used to determine the amount of withholding tax infringed the freedom to provide services.

In response to the first question, the CJEU found that imposing withholding tax did not in itself infringe the freedom to provide services. However, in response to the second, the CJEU found that prohibiting non-residents from obtaining a deduction for financing costs and other expenses was an infringement. This was the case notwithstanding the fact that non-residents were taxed at a lower rate.

The CJEU therefore held that interest withholding taxes which tax non-resident financial institutions on a gross basis are contrary to EU law.

Can withholding taxes be modified so as to remain lawful following *Brisal*?

The CJEU's reasoning explicitly permits withholding taxes to be applied on a net basis, and one might therefore expect those EU tax authorities still imposing interest withholding taxes to make appropriate modifications to their tax codes.

There are, however, both practical and technical difficulties with this.

The practical difficulty is determining quite how withholding tax can apply to net profits. The CJEU was clear that withholding taxes would have to be calculated on the basis of a lender's actual overheads and financing costs, and not some notional figures. Hence it seems to us that any net withholding tax would have to work on the basis of an initial estimation of overheads/costs and a subsequent "true-up". This would not be an entirely straightforward system to administer (quite aside from the difficulty of assessing a foreign entity's overheads and costs).

The technical difficulty is that most EU financial institutions lending to EU borrowers will be able to rely on a double taxation treaty between the two parties' jurisdictions, and typically this treaty will prohibit the borrower's jurisdiction from taxing the lender on its business profits. However, the kind of net withholding permitted by the *Brisal* judgment appears very like a tax on the lender's business profits. Hence net withholding taxes may not in fact be compatible with double tax treaties.

If that is correct, then the effect of Brisal is actually to abolish withholding tax on interest paid to EU financial institutions.

Does the rule in *Brisal* extend to other cases?

Brisal concerned a commercial loan by a financial institution. However, in our view, the CJEU's reasoning would apply to any loan by an entity carrying on a business of lending for which it has associated expenses.

So, for example, a securitisation SPV or debt fund which makes loans to third party borrowers should be able to benefit from the *Brisal* judgment. An individual acquiring debt securities as part of his or her investment portfolio would likely not, and neither would a parent company which makes a loan to its subsidiaries.

It may also be that *Brisal* extends to payments other than interest. A company in the business of developing and licensing intellectual property and receiving royalty payments thereon may be subject to withholding taxes on those royalties. The withholding tax will typically (perhaps always) be on a gross basis, however an equivalent company in the licensee jurisdiction would likely be taxed on a net basis. These facts look very similar to *Brisal*. It therefore seems likely that royalty withholding taxes are susceptible to EU law challenge.

What steps should affected businesses take?

Businesses that are currently incurring withholding tax on interest or royalties paid within the EU may wish to obtain legal advice as to whether they should

continue to withhold tax. In some cases it will be prudent to withhold the tax but immediately file for a refund of the tax withheld.

Any business which has historically suffered material withholding tax on interest or royalties paid within the EU may also wish to obtain legal advice as to whether it can obtain a refund of the tax withheld. Appropriate steps should be taken to protect its position, which may include filing protective claims (having regard to any limitation periods).

Is the impact of *Brisal* affected by Brexit?

Until such time as the UK actually leaves the EU, the judgment in *Brisal* will continue to be potentially relevant to interest and royalties paid to or from the UK.

At this point it is uncertain what arrangements will apply as between the UK and the EU following Brexit, but our working assumption is that Brexit will prevent the application of *Brisal* (and most other EU law claims) to payments made post-Brexit, but will not prevent EU law claims relating to pre-Brexit payments.

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