JUDGMENT OF THE COURT (Fourth Chamber)

3 October 2013 (*)

(Free movement of capital – Tax legislation – Corporation tax – Interest paid by a resident company on funds lent by a company established in a non-member country – Existence of 'special relations' between those companies – Thin capitalisation rules – No right of deduction in relation to interest on the part of the overall debt regarded as excessive – Interest deductible if paid to a company resident in the national territory – Tax evasion and avoidance – Wholly artificial arrangements – Arm's length terms – Proportionality)

In Case C?282/12,

REQUEST for a preliminary ruling under Article 267 TFEU from the Tribunal Central Administrativo Sul (Portugal), made by decision of 29 May 2012, received at the Court on 6 June 2012, in the proceedings

Itelcar – Automóveis de Aluguer Lda

v

Fazenda Pública,

THE COURT (Fourth Chamber),

composed of L. Bay Larsen, President of the Chamber, K. Lenaerts, Vice-President of the Court, acting as Judge of the Fourth Chamber, J. Malenovský, U. Lõhmus (Rapporteur) and M. Safjan, Judges,

Advocate General: N. Wahl,

Registrar: V. Tourrès, Administrator,

having regard to the written procedure and further to the hearing on 11 April 2013,

after considering the observations submitted on behalf of:

– Itelcar – Automóveis de Aluguer Lda, by P. Vidal Matos and D. Ortigão Ramos, advogados,

– the Portuguese Government, by L. Inez Fernandes, J. Menezes Leitão and A. Cunha, acting as Agents,

– the European Commission, by M. Afonso and W. Roels, acting as Agents,

having decided, after hearing the Advocate General, to proceed to judgment without an Opinion,

gives the following

Judgment

1 This request for a preliminary ruling concerns the interpretation of Article 56 EC and Article 58 EC.

2 The request has been made in proceedings between Itelcar – Automóveis de Aluguer Lda ('Itelcar') and the Fazenda Pública (Portuguese Treasury) concerning the partial non-deductibility of interest paid to GE Capital Fleet Services International Holding, Inc. ('GE Capital'), an American company, on credit which it had extended to Itelcar.

The relevant provisions of Portuguese law

3 In the Corporation Tax Code (Código do Imposto sobre o Rendimento das Pessoas Colectivas), in the version resulting from Decree-Law No 198/2001 of 3 July 2001, as amended by Law No 60?A/2005 of 30 December 2005 ('the CIRC'), Article 61, entitled 'Thin capitalisation', provides:

'1. Where the overall debt owed by a taxable person to an entity not resident in Portuguese territory or in another Member State of the European Union, with which that person has special relations within the meaning of Article 58(4), adapted as necessary, is excessive, the interest relating to the part regarded as excessive shall not be deductible for the purposes of determining the taxable profit.

2. Special relations shall be deemed to exist where, in respect of the overall debt owed by the taxable person to a third party not resident in Portuguese territory or in another Member State of the European Union, an entity referred to in Article 58(4) has provided a warranty or a guarantee.

3. The overall debt shall be regarded as excessive where, at any time during the tax year, the sum of the debts owed to each of the entities referred to in paragraphs 1 and 2 exceeds double the amount of that entity's holding in the taxable person's equity capital.

4. For the purposes of calculating overall debt, account shall be taken of all forms of credit, whether in cash or in kind, whatever the type of remuneration agreed, extended by the entity with which there are special relations, and including credit deriving from commercial transactions, where more than six months have passed since the debt became due.

5. For the purposes of calculating equity capital, the subscribed and paid-up share capital shall be added to the other items categorised as such by the accounting rules in force, with the exception of those items that reflect potential or unrealised capital gains or capital losses, in particular those resulting from re-evaluations not permitted under tax legislation or from the application of the equity method of accounting.

6. With the exception of cases of debts owed to an entity resident in a country, territory or region with a significantly more favourable tax regime, which has been placed on the list approved by order of the Minister for State and Finance, paragraph 1 shall not apply if, the coefficient referred to in paragraph 3 being exceeded, the taxable person demonstrates – taking into account the type of activity, the sector in which that activity is carried on, the volume and other relevant criteria, and taking account of a risk profile for the transaction that is not predicated upon the involvement of entities with which it has special relations – that it could have obtained the same level of credit, on similar terms, from an independent entity.

7. The evidence referred to in paragraph 6 must include the tax file referred to in Article 121.'

4 Article 58(4) of the CIRC, to which paragraphs 1 and 2 of Article 61 refer, is worded as follows:

‘Special relations shall be deemed to exist between two entities in situations in which one entity has the power to exercise, directly or indirectly, significant influence over the management decisions of the other, a power which shall be regarded as established, inter alia, between:

(a) an entity and those of its shareholders, or their spouses, ascendants or descendants, who hold, directly or indirectly, not less than 10% of the capital or the voting rights;

(b) entities in which the same shareholders, their spouses, ascendants or descendants hold, directly or indirectly, not less than 10% of the capital or the voting rights;

(c) an entity and the members of its governing bodies, or of any board of directors, administrative, management or supervisory board, and their spouses, ascendants and descendants;

(d) entities in which the majority of the members of the governing bodies or the members of any board of directors, administrative, management or supervisory board are the same people or, in the case of different people, are related to each other by marriage, legally recognised civil partnership or direct linear family relationship;

(e) entities linked by a contract governing the relationship between companies, establishing subordination or a group of equals, or other contract of equivalent effect;

(f) entities in a control relationship, within the meaning of the legislation laying down the obligation to draw up consolidated financial accounts;

(g) entities between which, as a result of the commercial, financial, business or legal relations between them, whether established or applied directly or indirectly, there is a de facto position of dependence in respect of the carrying out of the activity concerned, inter alia, where one of the following situations arises between them:

(1) the carrying out of the activity by one entity is substantially dependent on the assignment of industrial or intellectual property rights or knowhow held by the other;

(2) one entity is substantially dependent on the other for the supply of raw materials or access to sales networks for products, goods or services;

(3) a substantial part of the activity of one entity can only be carried out with the other or is dependent on decisions taken by the other;

(4) one entity has the right, pursuant to a legal measure, to set the prices or other terms of equivalent economic effect relating to goods or services traded, supplied or purchased by the other;

(5) pursuant to the rules and conditions governing their commercial or legal relations, one entity can make the management decisions of the other conditional upon matters or circumstances unrelated to the entities’ particular commercial or trade relationship.

(h) a resident entity or a non-resident entity with a permanent establishment situated in Portuguese territory and an entity subject to a significantly more favourable tax regime resident in a country, territory or region which has been placed on the list approved by order of the Minister for State and Finance.'

The dispute in the main proceedings and the question referred for a preliminary ruling

5 Itelcar is a Portuguese company whose main economic activity is the hiring out of light motor vehicles. Until 2005, Itelcar's share capital was held in its entirety by General Electric International (Benelux) BV, a Belgian company more than 10% of whose capital is held by GE Capital. Since 2006, 99.98% of Itelcar's capital has been held by that Belgian company and 0.02% by GE Capital.

6 On 23 July 2001, a loan agreement between Itelcar and GE Capital entered into force, for a period of 10 years, under which Itelcar had the use of a line of credit in return for the payment of interest at the Euribor rate, plus a 'spread' of 0.5%.

7 Under that agreement, the credit actually used by Itelcar amounted to EUR 122 072 179.97 in 2004, EUR 131 772 249.75 in 2005, EUR 212 113 789.46 in 2006 and EUR 272 113 789.46 in 2007.

8 Itelcar approached the Director General of Taxes in order to demonstrate that, for each of the years from 2004 to 2007, the level of credit that it had obtained from GE Capital could have been obtained on similar terms from an independent entity and that the spread in the interest rate agreed with GE Capital observed the 'arm's length principle'.

9 By notices of 5 December 2008 and 8 January 2009, Itelcar was informed that the final tax inspection reports made adjustments to the company's basis of assessment to tax for the years from 2004 to 2007, pursuant to Article 61 of the CIRC. Those reports found that there was excessive overall debt, as referred to in Article 61(3), and that the evidence adduced by Itelcar for the application of Article 61(6) was inconclusive.

10 In 2009, Itelcar filed two administrative appeals against the adjustments. Since those appeals were dismissed, Itelcar brought a new action before the Tribunal Administrativo e Fiscal de Sintra (Administrative and Tax Court of Sintra). That action was dismissed in part, on the ground that the provisions of national law applied in the case were not in breach of the free movement of capital enshrined in Article 56 EC.

11 Itelcar brought an appeal against the judgment of the Tribunal Administrativo e Fiscal de Sintra before the Tribunal Central Administrativo Sul (Administrative Court of Appeal, South), which takes the view that the outcome of the proceedings before it turns on the compatibility with European Union law of the relevant provisions of the CIRC.

12 In those circumstances, the Tribunal Central Administrativo Sul decided to stay the proceedings and to refer the following question to the Court for a preliminary ruling:

'Do Articles 63 [TFEU] and 65 [TFEU] (formerly Articles 56 [EC] and 58 [EC]) preclude legislation of a Member State, such as Article 61 of the CIRC … which, in connection with the overall debt of a taxable person residing in Portugal to an entity of a non-member country with which it maintains special relations within the meaning of Article 58(4) of the CIRC, does not allow interest borne and paid by that taxable person on the part of its overall debt regarded as excessive under Article 61(3) of the CIRC to be set off against tax on the same basis as interest borne and paid by a taxable person residing in Portugal who is found to be excessively indebted to an entity residing in Portugal with which it maintains special relations?'

The question referred for a preliminary ruling

13 By its question, the referring court asks, in essence, whether Article 56 EC must be interpreted as precluding rules of a Member State which provide that, where interest applied to the part of an overall debt categorised as excessive has been paid by a resident company to a lending company established in a non-member country with which the borrowing company has special relations, it is not deductible as an expense for the purposes of determining taxable profit, but where such interest is paid to a resident lending company with which the borrowing company has special relations, it is deductible for those purposes.

The applicable freedom

14 As regards the applicability of Article 56 EC to the facts of the case before the referring court, it should be noted at the outset that financial loans and credits granted by non-residents to residents constitute movements of capital for the purposes of that provision, as has been stated, moreover, under heading VIII of the nomenclature set out in Annex I to Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty [Article repealed by the Treaty of Amsterdam] (OJ 1988 L 178, p. 5) and in the explanatory notes set out therein (see, to that effect, Case C?452/04 *Fidium Finanz* [2006] ECR I?9521, paragraphs 41 and 42).

15 However, the Portuguese Government contends that the rules at issue in the main proceedings constitute a regime based on the existence of ‘special relations’ arising from the fact that the lending entity has the power to exert, directly or indirectly, a significant influence over the management and financing decisions of the borrowing entity. The Court has examined such regimes exclusively in the light of freedom of establishment, which does not apply to transactions carried out, as in this case, with an entity established in a non-member country.

16 In that connection, the Court has held, in relation to national legislation on the tax treatment of dividends originating in a non-member country, that it is sufficient to examine the purpose of that legislation in order to determine whether the tax treatment falls within the scope of the EC Treaty provisions on the free movement of capital. Since the Treaty chapter on freedom of establishment does not contain any provision which extends the application of its provisions to situations concerning the establishment of a company of a Member State in a non-member country or the establishment of a company of a non-member country in a Member State, such legislation cannot fall within the scope of Article 43 EC (see Case C?35/11 *Test Claimants in the FII Group Litigation* [2012] ECR, paragraphs 96 and 97 and the case-law cited).

17 The Court has also held that, where it is apparent from the purpose of such national legislation that it can apply only to those shareholdings which enable the holder to exert a definite influence on the decisions of the company concerned and to determine its activities, neither Article 43 EC nor Article 56 EC may be relied upon (C?35/11 *Test Claimants in the FII Group Litigation*, paragraph 98).

18 On the other hand, national rules relating to the tax treatment of dividends coming from a non-member country which do not apply exclusively to situations in which the parent company exerts decisive influence over the company paying the dividends must be assessed in the light of Article 56 EC. A company resident in a Member State may therefore rely on that provision in order to call into question the legality of such rules, irrespective of the size of its shareholding in the company paying dividends established in a non-member country (*Test Claimants in the FII Group Litigation*, paragraph 99, and Case C?168/11 *Beker* [2013] ECR, paragraph 30).

19 Such considerations are applicable to national rules, such as those at issue in the main

proceedings, which relate to the tax treatment of interest paid by a resident company to a lending company established in a non-member country, with which it has special relations. Such rules would not fall within the scope of Article 43 EC or Article 56 EC if they concerned only situations in which the lending company's shareholding in the resident borrowing company enabled it to exert a definite influence over the latter.

20 So far as concerns the rules at issue in the main proceedings, the term 'special relations', as defined in Article 58(4) of the CIRC, does not – as Itelcar and the European Commission observe – relate only to situations in which the lending company of a non-member country exerts a definite influence, within the meaning of the abovementioned case-law of the Court, over the resident borrowing company by reason of its shareholding in that company. In particular, the situations listed in Article 58(4)(g) of the CIRC, which relate to the commercial, financial, business or legal relationships between the companies in question, do not necessarily involve the lending company holding shares in the borrowing company.

21 At the hearing, the Portuguese Government stated, however, in reply to a question put by the Court, that the rules apply only to situations in which the lending company has a direct or indirect shareholding in the borrowing company.

22 Nevertheless, even if the application of the rules at issue in the main proceedings is confined to situations concerning dealings between a borrowing company and a lending company holding at least 10% of the shares or voting rights in the borrowing company, or between companies in which the same shareholders have such a holding, as contemplated in Article 58(4)(a) and (b) of the CIRC, it is clear that a holding of such a size does not necessarily imply that the holder exerts a definite influence over the decisions of the company of which it is a shareholder (see, to that effect, Case C?251/98 *Baars* [2000] ECR I?2787, paragraph 20, and Case C?446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I?11753, paragraph 58).

23 It follows that a resident company may, irrespective of whether the lending company of the non-member country has a shareholding in it, or of the size of any such shareholding, rely upon the Treaty provisions on the free movement of capital in order to call into question the legality of such national rules (see, by analogy, Case C?35/11 *Test Claimants in the FII Group Litigation*, paragraph 104).

24 Moreover, in the circumstances of this case there is no risk, from the interpretation of those Treaty provisions in the light of relations with non-member countries, that lending companies established in those countries, which do not fall within the limits of the territorial scope of freedom of establishment, can profit from that freedom. Contrary to the assertions made by the Portuguese Government at the hearing, national rules such as those at issue in the main proceedings do not relate to the conditions for the access of such companies to the market in the Member State concerned, but relate only to the tax treatment of interest on overall debts regarded as excessive that are entered into by a resident company with a company of a non-member country, with which it has special relations within the meaning of Article 58(4) of the CIRC (see, by analogy, Case C?35/11 *Test Claimants in the FII Group Litigation*, paragraph 100).

25 It follows that rules such as those at issue in the main proceedings must be examined exclusively in the light of the free movement of capital enshrined in Article 56 EC.

The existence of a restriction and possible justifications

26 It should be borne in mind that, according to settled case-law, although direct taxation falls within the competence of the Member States, they must nonetheless exercise that competence in accordance with European Union law (Joined Cases C?338/11 to C?347/11 *Santander Asset Management SGIIC and Others*

[2012] ECR, paragraph 14 and the case-law cited).

27 It also follows from settled case-law that the measures prohibited by Article 56(1) EC, as restrictions on the movement of capital, include those that are of such a kind as to discourage non-residents from making investments in a Member State or to discourage that Member State's residents from doing so in other States (Case C?370/05 *Festersen* [2007] ECR I?1129, paragraph 24, and *Santander Asset Management SGIIC and Others*, paragraph 15).

28 In the present case, it is apparent from Article 61(1) of the CIRC that, where the overall debts owed by a resident company to a company established in a non-member country, with which it has special relations within the meaning of Article 58(4) of the CIRC, are regarded as excessive in accordance with Article 61(3), the interest relating to the excessive part of the debt is not deductible for the purposes of determining the taxable profit of that resident company.

29 By contrast, it is also apparent from Article 61(1) of the CIRC that the deduction of such interest is permitted where the lending company resides in Portuguese territory or in another Member State.

30 As the Portuguese Government concedes, should the Court take the view that the situation at issue in the case before the referring court falls within the scope of the free movement of capital, that situation involves less favourable tax treatment for a resident company which contracts overall debts in excess of a certain level with a company established in a non-member country than for a resident company which contracts such debts with a company residing in the national territory or in another Member State.

31 Disadvantageous treatment of that kind is liable to deter a resident company from entering into credit arrangements in a manner regarded as excessive with a company established in a non-member country, with which it has special relations within the meaning of the rules at issue in the main proceedings. Consequently, it constitutes a restriction on the free movement of capital, which is prohibited, in principle, by Article 56 EC.

32 According to settled case-law, such a restriction may be permissible if it is justified by an overriding reason in the public interest. It is also necessary, in such a case, that the restriction be appropriate for ensuring the attainment of the objective in question and not go beyond what is necessary to attain that objective (see Case C?35/11 *Test Claimants in the FII Group Litigation*, paragraph 55 and the case-law cited).

33 The Portuguese Government argues that the rules at issue in the main proceedings are intended to combat tax evasion and avoidance by preventing the practice of 'thin capitalisation', which consists in eroding the basis of assessment for corporation tax in Portugal through the payment of interest, which is deductible, instead of profits, which are not deductible. That practice involves the arbitrary transfer of taxable revenues from that Member State to a non-member country, as a result of which the profits of a company are not taxed in the State in which those profits have been generated.

34 In that connection, it should be recalled that, according to settled case-law, a national measure restricting the free movement of capital may be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory (see, to that effect, Case C?524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I?2107, paragraphs 72 and 74, and Case C?182/08 *Glaxo Wellcome* [2009] ECR I?8591, paragraph 89).

35 By providing that certain interest paid by a resident company to a company established in a non-member country, with which it has special relations, is not to be deductible for the purposes of determining the taxable profit of that resident company, rules such as those at issue in the main proceedings are capable of preventing practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory. It follows that such rules are an appropriate means of attaining the objective of combatting tax evasion and avoidance (see, by analogy, Case C?524/04 *Test Claimants in the Thin Cap Group Litigation*, paragraph 77).

36 Nevertheless, it must be ascertained whether those rules go beyond what is necessary in order to attain that objective.

37 In that connection, it is apparent from the case-law of the Court that, where rules are predicated on an assessment of objective and verifiable elements for the purposes of determining whether a transaction represents a wholly artificial arrangement entered into for tax reasons alone, they may be regarded as not going beyond what is necessary to prevent tax evasion and avoidance, if, on each occasion on which the existence of such an arrangement cannot be ruled out, those rules give the taxpayer an opportunity, without subjecting him to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction (see, to that effect, Case C?524/04 *Test Claimants in the Thin Cap Group Litigation*, paragraph 82, and Case C?318/10 *SIAT* [2012] ECR, paragraph 50).

38 Similarly, the Court has held that, where the transaction in question goes beyond what the companies concerned would have agreed on an arm’s length basis, the corrective tax measure must, in order not to be considered disproportionate, be confined to the part which exceeds that which would have been agreed on that basis (see, to that effect, Case C?524/04 *Test Claimants in the Thin Cap Group Litigation*, paragraph 83, and *SIAT*, paragraph 52).

39 In the present case, it is true that Article 61(6) of the CIRC provides that, except in cases of debts owed to an entity resident in a country, territory or region with a significantly more favourable tax regime, the resident company which has contracted credit arrangements regarded as excessive with a company from a non-member country, with which it has special relations, may demonstrate that it could have obtained the same level of credit, on similar terms, from an independent entity. Secondly, under Article 61(1) of the CIRC, only the interest relating to the part of the overall debt that is regarded as excessive is not deductible.

40 Nevertheless, rules such as those at issue in the main proceedings go beyond what is necessary in order to attain their objective.

41 As can be seen from paragraph 20 above, the term ‘special relations’, as defined in Article 58(4) of the CIRC, encompasses situations that do not necessarily involve the lending company of a non-member country holding shares in the resident borrowing company. Where there is no such shareholding, the effect of the method for calculating the excess indebtedness laid down in Article 61(3) of the CIRC is that any credit arrangement between those two companies falls to be regarded as excessive.

42 It is clear that, in the circumstances described in the paragraph above, the rules at issue in the main proceedings also affect conduct the economic reality of which cannot be disputed. In presuming that, in such circumstances, the basis of assessment for corporation tax payable by the resident borrowing company is being eroded, those rules go beyond what is necessary to attain their objective.

43 Moreover, in so far as the rules at issue in the main proceedings are applied – in accordance with the statements made by the Portuguese Government, as summarised in paragraph 21 above – only to situations in which the lending company has a direct or indirect shareholding in the borrowing company, so that the situation referred to in paragraph 41 above does not arise, the fact remains that such a limitation on the scope of those rules does not follow from their wording, which tends, on the contrary, to suggest that they do cover special relations where there is no such shareholding.

44 That being so, the rules in question do not make it possible, at the outset, to determine their scope with sufficient precision. Accordingly, they do not meet the requirements of legal certainty, in accordance with which rules of law must be clear, precise and predictable as regards their effects, especially where they may have unfavourable consequences for individuals and companies. As it is, rules which do not meet the requirements of the principle of legal certainty cannot be considered to be proportionate to the objectives pursued (see *SIAT*, paragraphs 58 and 59).

45 In light of the foregoing, the answer to the question referred is that Article 56 EC must be interpreted as meaning that, in the case of rules of a Member State which provide that, where interest applied to the part of an overall debt categorised as excessive has been paid by a resident company to a lending company established in a non-member country with which the borrowing company has special relations, it is not deductible as an expense for the purposes of determining taxable profit, but where such interest is paid to a resident lending company with which the borrowing company has special relations, it is deductible for those purposes, those rules are precluded where, if the lending company established in a non-member country does not have a shareholding in the resident borrowing company, they nevertheless presume that the overall debt owed by the borrowing company forms part of an arrangement designed to avoid the tax normally payable or where they do not make it possible, at the outset, to determine their scope with sufficient precision.

Costs

46 Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court. Costs incurred in submitting observations to the Court, other than the costs of those parties, are not recoverable.

On those grounds, the Court (Fourth Chamber) hereby rules:

Article 56 EC must be interpreted as meaning that, in the case of rules of a Member State which provide that, where interest applied to the part of an overall debt categorised as excessive has been paid by a resident company to a lending company established in a non-member country with which the borrowing company has special relations, it is not deductible as an expense for the purposes of determining taxable profit, but where such interest is paid to a resident lending company with which the borrowing company has special relations, it is deductible for those purposes, those rules are precluded where, if the lending company established in a non-member country does not have a shareholding in the resident borrowing company, they nevertheless presume that the overall debt owed by the borrowing company forms part of an arrangement designed to avoid the tax normally payable or where they do not make it possible, at the outset, to determine their scope with sufficient precision.

[Signatures]

* Language of the case: Portuguese.