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Avoidance of International Double Taxation: A Plea for the Exemption System in Portugal

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Throughout modern history, problems have arisen from the taxation of goods, labor and capital which move across jurisdictions. These problems have involved such questions as the entitlement to tax by one jurisdiction of income, products or wealth which belong to residents of another, or which have been created in another; questions of fair treatment of taxpayers resident in one place but earning income or wealth in another have also been raised; and there has been concern with the effects of multi-jurisdictional taxation on trade, capital and labor movements across regions, localities and nations.

Peggy Musgrave and Richard Musgrave ([1])

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(1) *Fiscal Coordination and Competition in an International Setting, Influence of Tax Differentials on International Competitiveness*. Proceedings of the VIIIth Munich Syposium on International Taxation, Kluwer Law and Taxation Publishers, Deventer, Boston, 1990, p. 61.

INTRODUCTION

Situations of double taxation should be avoided because they violate one of the more important principles of taxation in modern states: the principle of neutrality. In effect, as it is certain that it is impossible to avoid taxes, it is also certain that being taxed twice creates inefficiencies and makes the tax element becoming an element with a preponderant role in taxpayers decisions representing an intromission of the state in the market, thereby influencing decisions that should not be tax driven.

In the international context that is the background of this thesis the danger of the tax factor is not to influence the decision between savings and investment ([2]), but where to invest. In effect, in a cross-border situation, the taxation at the source state as well as (or combined with) the taxation at the residence state of the investor may influence not only the decision to go abroad, but also the decision of where to go abroad.

In an international situation and without measures designed to combat it, double taxation is most certainly unavoidable. Therefore, taking into account the combination of the generally accepted principles of international tax law according to which each state is entitled to tax the revenues produced within its borders as well as that states are entitled to tax their residents on their worldwide income ([3]), it is normal that each

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[2] Although in an international environment the tax element may also be of relevance on the option between savings and investment, mainly in what concerns high net worth individuals ("HNWI") and multinational enterprises ("MNEs"), we will focus solely on the influence it may represent in the location of investment.

[3] See, for instance, RICHARD J. VANN, *International Aspects of Income Tax* in VICTOR THURONYI (ed.), Tax Law Design and Drafting, Vol. 2, Ch. 18, p. 4, International Monetary Fund, 1998. For a discussion on the distributive rules present in the OECD Model Tax Convention see LANG, PISTONE, SCHUCH, STARINGER (eds.), *Source versus Residence. Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*, Kluwer Law International Eurotax Series on European Taxation, Vol. 20, 2008. For a discussion of the difficulties underlying the concepts of source and residence, see, for instance, KLAUS VOGEL, *World-wide vs. Source Taxation of Income – A Review*

state tax system tends to create tax rules in order to avoid the double taxation created by the operation of these two international tax principles. These rules play an important role in promoting investment (or, at least, eliminating barriers to it) and cross-border exchange of goods and services which, ultimately, can promote the wealth of citizens in a given country (and, consequently, of the state) as well as, in a macroeconomic perspective, contribute to an efficient allocation of capital and productive factors.

Due to the magnitude of this subject it is not obviously our purpose in this dissertation to deal with every single aspect of this subject. The author purpose is to present an argument against the system in force in Portugal – as a rule the foreign tax credit – and an argument in favour of the exemption system.

The Portuguese economy has been dealing for several decades with a competitiveness issue and for that reason the author felt compelled to approach the matter of avoidance of double taxation having the referred competitiveness issue of this country in mind.

The author will begin with a very brief synopsis of the theoretical background behind the two most used systems (credit system and exemption system) to eliminate

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and Reevaluation of Arguments, Influence of Tax Differentials on International Competitiveness. Proceedings of the VIIIth Munich Syposium on International Taxation, Kluwer Law and Taxation Publishers, Deventer, Boston, 1990, p. 117 and ff.; ANGEL SCHINDEL and ADOLFO ATCHABAHIAN, *General Report*, Source and Residence: new configuration of their principles, cahiers de droit fiscal international, Vol. 90a, IFA, 2005; RUI DUARTE MORAIS, *Imputação de Lucros de Sociedades Não Residentes sujeitas a um Regime Fiscal Privilegiado, Controlled Foreign Companies O Art.º 60.º do C.I.R.C.*, Publicações Universidade Católica, Porto, 2005, pp. 132-157; ANTÓNIO FERNANDES DE OLIVEIRA, *A residência, a fonte e a tributação. Ensaio elaborado para efeitos da candidatura ao «Prémio 40 Anos da Associação Fiscal Portuguesa»*, Ciência e Técnica Fiscal 420, 2007, p. 220 and ff.; PAULA ROSADO PEREIRA, *Princípios do Direito Fiscal Internacional. Do Paradigma Clássico ao Direito Fiscal Europeu*, Almedina, Coimbra, 2010, p. 85 and ff.

international double taxation. The scope of the first chapter is to contextualize the reader with the theoretical arguments behind the discussion in order to be fully aware of the principles and consequences of each system and not to enter in the theoretical discussions in favour of any of the theories and economic principles and motives underlying each system.

In the second chapter the author will make a description of the rules to avoid double taxation in force in Portuguese domestic law and double tax conventions followed, in the third chapter, by a brief comparative overview of the rules to avoid international double taxation in other relevant economies.

Finally, the author will argument why the exemption system should be followed in Portugal in detriment of the existent credit system and the reasons why the move to the exemption system in Portugal will bring benefits to the Portuguese economy.

CHAPTER I: ECONOMIC AND THEORECTICAL CONTEXT OF THE ELIMINATION OF DOUBLE TAXATION OF INCOME

1. Principle of neutrality

The principle of neutrality is a crucial and international tax policy principle, which is based in the non-discrimination principle, that provides that taxation shall have a minimum impact in the economic agents decision to allocate, or not to allocate, resources in a certain economy, and also shall represent a positive influence in competition ([4]) ([5]).

In Portugal, although it is not difficult to convene on the importance of this principle, its role is being primarily played in the drafting of the law and of the tax system, rather than being used by the case law to render illegal laws on the application/interpretation of such laws by the tax authorities that could be argued that violated this principle.

2. Double taxation of income

Double taxation is when the same income is taxed twice. The Authors distinguish

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(4) For further developments on this principle see SVEN-ERIK JOHANSSON, *The Utopia of Neutral Taxation*, in GUSTAF LINDENCRONA, SVEN-OLOF LODIN, BERTIL WIMAN (eds.), International Studies in Taxation: Law and Economics. Liber Amicorum Leif Mutén, Series on International Taxation 21, Kluwer Law International, 1999, pp. 169 and 186; RAMON JEFFREY, *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation 23, Kluwer Law International, 1999, pp. 4-12; PAULA ROSADO PEREIRA, *op. cit.*, p. 67 and ff.

(5) For further developments see, for instance, MANUEL PIRES, *Da Dupla Tributação Jurídica Internacional sobre o Rendimento*, CEF, 1984, p. 103 e ff., and ALBERTO XAVIER, *Direito Tributário Internacional*, 2.ª Edição Actualizada (com a colaboração de CLOTILDE CELORICO PALMA e LEONOR XAVIER), Almedina, Coimbra, 2007, p. 35.

between economic double taxation and juridical double taxation ([6]). The first is when the same income is taxed twice in different taxable persons (e.g. taxation of profits in the hands of the company and the taxation of dividends in the hands of the shareholder), and the second is when the same income is taxed twice to the same taxable person on the same tax base (e.g. distribution of dividends taxed in the source state by the way of withholding tax and in the residence state of the shareholder).

Accordingly, international juridical double taxation occurs where, within the same period, the same taxpayer is subject to comparable taxes on the same subject by two different states, while international economic double taxation occurs where the same economic transaction is subject to tax in two states in the same period, but in the hands of different taxpayers.

The concept of international juridical double taxation is more operative than the concept of international economic double taxation. In effect it is easy to find situations of international juridical double taxation. In what concerns international economic double taxation the fluidness of this economic concept clashes with the rigidity of the legal categories. In practice situations of international economic taxation occur only in relation to dividends because it is recognised that shareholder's dividends have the same nature as company profits.

Theoretically both economic and juridical double taxation can be domestic or international. In practice, domestic juridical double taxation is not an issue as domestic tax systems grant measures to eliminate it. Domestic economic double taxation may be more often to find in domestic tax systems.

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(6) DANIEL S. SMITH, *The Haribo and Osterreichische Salinen Cases: To What Extent Is the ECJ Willing To Remove International Double Taxation Caused by Member States?*, 51 European Taxation 7, July 2011, Journals IBFD.

3. Capital export neutrality, capital import neutrality ([7]) and the new concepts

In world trade the interests of rich industrialized countries are not coincident with the interests of the poor, thin capitalized and unindustrialized countries. While the formers are concerned namely that their citizens decisions to invest home or abroad ultimately should be defined by the after tax rate return of the investment and consequently that the tax system does not distort the decision to invest home or abroad as well as to creating conditions so that their producers may have access to foreign markets less saturated than the domestic market. On the other hand, the latter are interested in attracting foreign capital and investment and in ensuring, to the extent possible, that capital is not moved abroad.

Based in these antagonist public realities, economists and public financers in the post second war developed the theoretical (and opposite) concepts of capital export neutrality and capital import neutrality, respectively.

Capital export neutrality ("CEN") holds when an investor faces the same effective tax rate on its investments, wherever those investments are located. Capital import neutrality ("CIN") holds if all investments undertaken in the same jurisdiction face the same effective tax rate ([8]). Therefore, CEN is a concept under which investors shall

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[7] Introduced by RICHARD MUSGRAVE in 1960 then broadened by PEGGY RICHMAN in 1963 (after marrying RICHARD MUSGRAVE, PEGGY MUSGRAVE). For a summary of PEGGY MUSGRAVE studies in this matter see KIM BROOKS, *Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Policy Objective*, JOHN HEAD and RICHARD FREVER (eds.), Tax Reform in the 21st Century. A Volume in Memory of RICHARD MUSGRAVE, Series in International Taxation 34, Kluwer Law International, 2009, pp. 471-493.

[8] MICHAEL DEVEREUX, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, JOHN HEAD and RICHARD FREVER (eds.), Tax Reform in the 21st Century. A Volume

pay tax in their residence country, and both home country investments and foreign investments shall receive the same tax treatment, being that taxes should not determine the location of investment ([9]). On the other hand, CIN is a concept under which investors shall pay tax in the source country, regardless of their home country, and taxes should not determine if resident or non-resident investors make certain investments.

CEN has a residence-based approach, commonly applicable to rich industrialized countries ([10]), which aims neutrality by taxing only in the country of residence ([11]), according to the principle of worldwide taxation, and elimination of double taxation is possible by the granting a full tax credit. This concept requires immediate taxation of foreign income with no deferral.

CIN is a concept with a source-based approach, which also aims neutrality, that is being increasingly adopted by several countries, under which residence countries shall ignore foreign income (by granting full exemption) and tax in accordance with the principle of territoriality. Both CEN and CIN constitute mere theoretic concepts as no

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in Memory of RICHARD MUSGRAVE, Series in International Taxation 34, Kluwer Law International, 2009, pp. 500-523.

[9] European Commission, Directorate-General Taxation on Customs Union, CCCTB WG, *General Tax Principles*, Brussels, December 2004, paragraph 14, p. 4.

[10] As the United States (with important elements of capital import neutrality, as stressed by C. NEIL STEPHENS, *A Progressive Analysis of the Efficiencies of Capital Import Neutrality*, Law and Policy in International Business, Vol. 30, 1998).

[11] As referred by the common consolidated corporate tax base working group ("CCCTB") *"(...) This is generally considered to be achieved notably by income only being taxed in the country of residence with no distinguish between domestic and foreign source income – i.e. a residence-based worldwide approach to taxation needs to be adopted by all countries (...).*" in European Commission, Directorate-General Taxation on Customs Union, CCCTB WG, *General Tax Principles*, Brussels, December 2004, paragraph 14, p. 4.

tax system fully applies one or another and the merits of each concept which have been highlighted by the respective supporters (without, however, reaching a final conclusion on the debate), rely on one important detail: all countries should adopt simultaneously one of these two taxation systems.

Other interesting related theoretical concepts with regard to neutrality are also found in the literature, such as the concept of capital ownership neutrality ("CON"), under which the tax system should not distort the ownership of assets ([12]), with the adoption of full credit or exemption methods; the concept of national neutrality ("NN"), under which the tax system shall encourage national investments if the pre-tax rate of return is superior to the return on a foreign investment net of foreign taxes (foreign tax payments are deducted); the concept of national ownership neutrality ("NON"), under which foreign investments that yield a higher after-tax rate of return than domestic investments shall be encouraged*;* and, defensive neutrality (hybrid systems), under which foreign investment in high-tax countries shall be discouraged ([13]).

[12] Ownership neutrality or savings neutrality, as defined by Professor MICHAEL S. KNOLL, when it is deemed as "*a tax system that does not distort the ownership of assets*" or "*a tax system that does not distort the consumption*" in KNOLL, MICHAEL S., *Reconsidering International Tax Neutrality*, May 13, 2009, University of Pennsylvania Law School, Institute for Law & Economy Research Paper No. 09-16.

[13] GEORG KOFLER, *op. cit.* p. p. 78-80. See also BRUNO SANTIAGO, *O princípio da não-discriminação no cruzamento do Direito Fiscal Internacional com o Direito Fiscal Comunitário*, Cadernos de Ciência e Técnica Fiscal 207, CEF, 2009, pp. 14-24.

4. Credit system and exemption system ([14])

The way tax systems are designed may influence the public policy pursued by the states. In result the credit and exemption mechanisms to eliminate international double taxation used by countries since the mid-twenties of the last century ([15]), were linked with the concepts explained in the previous section.

The credit method is adopted by countries that tax according to the worldwide principle, which means that resident taxpayers are taxed on their income from domestic and foreign sources. The concept of residence is therefore crucial in this system as it represents the distinctive criteria between taxpayers with a worldwide tax liability and nonresident taxpayers with limited liability.

The credit method is subdivided in three different modalities. First, the most uncommon, is the full credit method. By adopting this method, residence countries would be in practice financing the tax system of the source state because under this

[14] These systems are explained more or less extensively in International Tax Law literature. See, for instance, TEODORO CORDÓN EZQUERRO (dir.), *Manual de Fiscalidad Internacional*, 2.ª edición, Instituto de Estudios Fiscales, 2004; BRUNO GOUTHIÈRE, *Les impôts dans les affaires* internationals, 8 edition, Editions Francis Lefebvre, 2010, MICHAEL LANG, *Introduction to the Law of Double Tax Conventions*, IBFD, Linde, 2010, PETER HARRIS and DAVID OLIVER, *International Commercial Tax*, Cambridge Tax Law Series, 2010, GUGLIEMO MAISTO, *Credit versus Exemption under Domestic Tax Law and Treaties*, in MICHAEL LANG, PASQUALE PISTONE, JOSEF SCHUCH, CLAUS STARINGER, ALFRED STORCK, MARTIN ZAGLER (eds.), Tax Treaties: Building Bridges between Law and Economics, IBFD, 2010; JURGEN LUDICKE, *Exemption and Tax Credit in German Tax Treaties*, in PHILIP BAKER and CATHERINE BOBBETT (eds.), Tax Polymath. A Life in International Taxation, 2011.

[15] JOHN F. AVERY JONES in *Avoiding Double Taxation: Credit versus Exemption – The origins,* 66 Bulletin for International Taxation, 2, February 2012, Journals IBFD, p. 67 and ff..

method the residence state credits the tax paid at source even if higher than the tax paid at the residence in that income which is equivalent to a subsidy ([16]).

The ordinary credit method, as mentioned by the CCCTB working group of the European Commission ([17]) is when "*credit for the foreign tax is restricted to the amount of "domestic" tax on the corresponding foreign income so if the "domestic rate" is lower than the foreign rate the credit relief is restricted*".

Finally, when speaking about the credit method is important to mention the indirect credit method, not used in Portugal ([18]). The countries that adopt this method are crediting not only the tax paid in the source state by the beneficiary, but also the tax on the underlying income. The most common illustration of this method is when the State of the parent company grants a credit not only for the tax charged at source on the dividends distributed by the subsidiary but also the fraction of the corporation tax paid by the subsidiary which relates to the profits that are being distributed as dividends. As it easily perceived, the adoption of this method (i.e. United Kingdom and United States) requires detailed rules to define the conditions in which a credit for the underlying tax can be granted ([19]).

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[16] This method is used in Portugal in one specific circumstance due to the application of a common system between Member States of the EU. We are referring to the so-called Savings Directive. Under this Directive, the residence State shall reimburse any excess tax withheld in the source State of the income in comparison with the tax due on that income in the residence State (see article 78(2) and (3) of the PITC).

[17] European Commission, Directorate-General Taxation on Customs Union, CCCTB WG, *The territorial scope of the CCCTB*, Working Document, Brussels, February 2006, note 4, p. 5.

[18] Except in case of CFCs where the domestic rule (article 66(4) of the CITC) establishes that to the profits of the CFC imputed to the Portuguese shareholder is deducted the tax paid on those profits in the CFC State.

[19] Professor GEORG KOFLER stated "*As the US Supreme Court noted with regard to the indirect or "deemed paid credit", which was enacted as early as 1918, this measure protects domestic*

Under the exemption system income of foreign sources is exempted in the home country. The exemption method is also subdivided in two main methods: the full exemption method and the exemption with progression method.

Under the former, the residence state exempts from tax the foreign revenue of the taxpayer. Under the latter, the residence state exempts the foreign revenue of the taxpayer but takes it into consideration when determining the tax to be imposed on the rest of the income.

Both credit and exemption methods can be used to eliminate juridical as well as economic double taxation, whether domestic or international.

Lastly, one has also to mention the deduction method of providing tax relief. As Peter Harris and David Oliver mention this method mitigates but does not relieve double taxation of cross-border income as it does not reduces the residence tax by the amount of the foreign tax (as happens in the credit system) but only reduces it in an amount equivalent to the residence state tax on the foreign tax ([20]). According to this method, which is seen as promoting national neutrality, the residence country allows the foreign tax to be deducted as an expense and, therefore, it is only considered the foreign after tax income.

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corporations that operate through foreign subsidiaries from double taxation, first by the foreign jurisdiction, when the income is earned by the subsidiary and, second, by the United States, when the income is received as a dividend by the parent ", in *Indirect Credit versus Exemption: Double Taxation Relief for Intercompany Distributions*, 66 Bulletin for International Taxation 2, February 2012, Journals IBFD, p 82.

[20] *Op. cit.*, p. 265.

CHAPTER II: THE PORTUGUESE LEGAL FRAMEWORK ON DOUBLE TAXATION

1. Introduction

The Portuguese system on income taxes is formed by two major diplomas – the Personal Income Tax Code ("PITC") that deals with the taxation of income derived by individuals ("PIT") and the Corporate Income Tax Code ("CITC") that establishes the rules for the taxation of income derived by legal entities ("CIT") – and several other laws and regulations that develop certain aspects not dealt in the two major legal diplomas ([21]).

In this chapter the author will make a description of the rules foreseen in the PITC and in the CITC to eliminate economic and juridical double taxation in a domestic as well as in an international scenario and the rules foreseen in the double taxation conventions ("DTC") in force.

2. Domestic scenario

a) Juridical double taxation

Juridical double taxation is not an issue in a domestic environment. This concept was mainly thought for international situations. Theoretically, a situation of domestic juridical double taxation could occur in case the payer of a certain item of income was obliged to withhold tax and this withholding could not be offset against the beneficiary final tax liability. However, the situations foreseen in the law where withholding tax is due are either situations where the withholding tax is the final tax on that income (and consequently there is no double taxation) or where the withholding tax is just a payment on account of the final tax liability of the taxpayer

[21] For further developments on the principle of legality in tax matters see Professor ANA PAULA DOURADO, *O Princípio da Legalidade Fiscal. Tipicidade, conceitos jurídicos indeterminados e margem de livre apreciação*, Almedina, Coimbra, 2007.

(and consequently there is also no double taxation). In the latter case the tax withheld is deducted to the PIT liability ("*dedução à colecta*") and, in case the tax withheld is higher than the final tax liability of the taxpayer, it will be entitled to a reimbursement (article 78(2)(3) of the PITC). The same is valid, *mutatis mutandis*, in case of CIT (see articles 90(2)(b) and 104(2) of the CITC).

In the exercise of applying the concept of juridical double taxation to real life it is possible to figure out marginal situations very close to juridical double taxation. We are referring to the case of the additional surtaxes implemented as a consequence of the crisis of the sovereign debt in Portugal. In relation to PIT, the Portuguese Parliament ("Parliament") approved for 2011 an extraordinary surtax of 3,5% on certain items of income subject to PIT (article 72-A of the PITC) ([22]) and for the years of 2012 and 2013 an additional surtax of 2,5% for taxable income subject to aggregation higher than € 153.300 (article 68-A of the PITC) ([23]).

In what concerns CIT, the Parliament approved an additional surtax called "*derrama estadual*" ([24]) (articles 87-A, 104-A and 105-A of the CITC) that is due at a rate that ranges between 3% and 5% for taxable profits higher than € 1.500.000 ([25]).

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[22] Excluding income taxed by the way of a final withholding tax (mainly investment income such as interest and dividends) and dividends that were not subject to withholding tax (which can be the case of dividends received directly from foreign companies), cases in which the surtax does not apply.

[23] Also, in principle, excluding investment income that, as a rule, is taxed by the way of a final withholding tax, except if the beneficiary chooses to aggregate this income with his remaining income.

[24] Law no. 12-A/2010, June 30, as amended by Law no. 64-B/2011, December 30.

[25] The legislator followed a technique similar to one with a long tradition in Portuguese tax law, the "*derrama municipal"*, an accessory tax that is collected together with the CIT, computed at a rate that can go up to 1,5% over the taxable profit, and that constitutes a revenue of the municipalities.

Although the illustrations made in the previous paragraph could be considered cases of domestic juridical double taxation (at least *in lato sensu*), the fact is that the concept of juridical double taxation is a concept mainly operative in cross-border situations. In domestic situations, although it is not impossible to occur, it is certainly less common. Moreover, specifically in the Portuguese legal framework, although there is not an express prohibition of domestic juridical double taxation, such cases could be rendered illegal in certain situations by the application of the ability to pay principle and the net profit principle that are established in the Portuguese Constitution as limits for the taxation of individuals and corporations, respectively.

In effect, a law that would create a situation of juridical double taxation with no limitation could be rendered null or void by the application of such principles. Furthermore, there is also a legal prohibition of the so-called "*duplicação de colecta*". This concept as defined in the law is "*when a certain tax is entirely paid, another tax of the same nature is demanded to the same or a different taxpayer, relatively to the same tax event and to the same period*" (article 205 of the Code on Procedural Tax Law).

b) Economic double taxation

As already noted above this concept is mainly operative for situations related with the taxation of profits. Situations of economic double taxation will often occur between corporate bodies and their individual or corporate shareholders.

Situations of economic double taxation should be avoided because they represent taxing the same income multiple times which is inefficient. Portuguese law foresees rules to mitigate these situations in certain circumstances. These rules that will be explained below, set certain requirements in order to benefit from them. For the

situations where the taxpayer does not accomplish with those legal requirements, economic double taxation is not eliminated.

In what concerns corporations (as well as cooperatives and public enterprises), article 51 of the CITC establishes that dividends received are not taxed, provided that: a) the distributing company has its head office or place of effective management in Portugal and is subject to and not exempt from CIT (or is subject to the special tax on gambling activities); and b) the recipient entity is not within the fiscal transparency regime; and c) the recipient entity has directly held a participation of not less than 10% in the capital of the distributing company ([26]) and has held such participation for an uninterrupted period of 1 year prior to the date on which the profits were placed at its disposal or, if held for a shorter period, it continues to hold it until the year-long condition is satisfied.

Prior to 2011, in the cases where requirements mentioned in b) and c) in the previous paragraph were not met, the law granted a partial (50%) elimination of economic double taxation. This half-exemption regime was created in 2001 for domestic dividends and extended in 2007 to European Union ("EU") dividends.
Presently in cases where the requirements to benefit from the elimination of economic double taxation are not met, there is no other sort of relief, differently from what happened by the time of the entry into force of the CITC (1989) and until 2001, where there was initially foreseen a 20% tax credit for the corporate income tax due on the dividends where the parent company did not meet the requirements to benefit from the exemption (in 1995 extended to 60%) ([27]).

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[26] Prior to 2011 in alternative to the holding percentage requirement, the participation exemption regime was also applicable to participations whose cost of acquisition was not less than € 20,000,000.

[27] According to M. H. FREITAS PEREIRA, this imputation system can be considered more a tax benefit than a measure to eliminate economic double taxation due to the low effective corporate income tax

In case of individual shareholders, dividends may be taxed either by withholding tax (currently at the rate of 26,5%) or by a special rate (also at 26,5%) in cases where withholding tax is not applicable, which in both cases is the final tax on such income except if the taxpayer chooses to aggregate the dividends with the remaining of his income, case in which the withholding tax is a payment on account of the final tax due and the dividend will only be considered for tax purposes in 50% of its amount. Therefore, in case of individual shareholders economic double taxation is never completely eliminated.

In the special taxation regime for venture capital investment funds (article 23 of Portuguese Tax Incentives Statute ("PTIS")) it is mentioned that the income received by corporate entities holders of participation units in those funds, is only considered in 50% by a remission to the regime of the CITC referred to above that that exempted half of the dividend and that was abolished in 2011. Therefore, it is not clear in case of corporate entities holders of participation units in venture capital funds if they are still entitled to the 50% exemption.

3. International scenario

a) Juridical double taxation

We will now focus our analysis in more detail in the Portuguese domestic rules to mitigate international juridical double taxation since these are the more frequent situations of international double taxation.

In what concerns PIT, the relevant rules are article 22(6) that establishes that the income obtained abroad is considered gross of the income taxes paid abroad, article

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rate of the company distributing the dividends, see *A tributação do lucro das empresas*, in O Economista, p. 211.

78 that establishes that the credit for international double taxation operates as a deduction to the personal income tax liability ("*dedução à colecta"*) ([28]) ([29]), and article 80, which establishes in more detail the functioning of the credit mechanism and that reads as follows:

"*1 - Recipients of different categories of income obtained abroad are entitled to a tax credit for international double taxation, up to a limit equal to the (Portuguese) tax proportional to such net income, determined in accordance with Article 22 (6) b), which shall be the lesser of the following amounts:*

a) The income tax paid abroad;

b) The fraction of the IRS liability, calculated before the credit, attributable to the income taxable in the country in question, net of specific deductions provided for in this Code.

2 - When there is a double taxation agreement between Portugal (and the source country of the income in question), the credit to be granted under the

[28] Briefly, the Personal Income Tax Code establishes different categories of income (investment income, independent work income, capital gains, etc.), then in relation to certain categories of income there are certain deductions applicable. After the application of such deductions it is obtained the taxable income of the taxpayer that is subject to a progressive tax rate. Once applied the relevant tax rate to the taxpayer's taxable income it is obtained the tax liability of the year. But, before reaching the personal income tax due there are still personal deductions to the tax liability (such as medical, educational expenses and the credit for international double taxation). This means that if the taxpayer has not enough tax liability to offset the credit for international double taxation that he is entitled, in practice a situation of international double taxation will occur has such credit if not used in the relevant year may not be carried back or forward.

[29] There is a special case, however, in which instead of applying the credit method, Portugal follows the exemption method. We are referring to the special regime available for non-habitual residents (the so-called Beckham regimes). In this special case Portuguese law (article 81(4) to (7) of the PITC) follows in relation to some items of income the full exemption method and in relation to others the exemption with progression.

preceding paragraph may not exceed the tax paid abroad as stipulated by convention." ([30]).

Similarly, in what concerns corporate entities resident in Portugal as well as permanent establishments located in Portugal of non-resident entities, the functioning of the ordinary foreign tax credit is dealt with in three different norms of the CITC. First, article 68 of CITC establishes that the income obtained abroad is considered gross of income taxes paid abroad. Then, article 90 (2)(a) of CITC stipulates that the credit for international double taxation operates as a deduction to the taxpayer's tax liability ([31]). Finally, article 91 of CITC establishes in more detail the functioning of the credit mechanism and reads as follows:

"*1 - The credit referred to in Article 90 (2) a) applies only when income earned abroad has been included in the taxable profit and is the lesser of the following amounts:*

a) the income tax paid abroad;

b) the fraction of the IRC, computed before the credit, which corresponds to income may be taxed in the source country, net of costs or losses incurred directly or indirectly in obtaining it.

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[30] Available for consultation purposes at http://info.portaldasfinancas.gov.pt and translated by WILLIAM CUNNINGHAM.

[31] In comparable terms to the system of personal income tax, in what concerns corporate income tax first it is determined the taxable profit of the company based on the profit determined in the annual accounts. Then, the taxable income is given by the difference between taxable profits and the deductions to the taxable profits (*maxime* tax losses). Afterwards a flat corporate income tax rate is applied to the taxable income of the subject in order to reach the corporate income tax liability of the year. This corporate income tax liability can then be subject to further deductions (foreign tax credit, tax incentives, special payment on account and withholding tax) in order to reach the corporate income tax due.

2 - Where a double taxation agreement (with the source country has been) concluded by Portugal, the credit to be made under the preceding paragraph may not exceed the tax paid abroad in accordance with the Convention." ([32]).

Also in this matter, it is note worth quoting a rule established for the application of the credit mechanism in what concern Portuguese investment funds that goes beyond the (identical) rules established in the personal and corporate income tax codes. We are referring to article (article 22 (15)(c) of the PTIS) that establishes that "*when income from different countries is obtained in the same year the deduction must be calculated separately for each type of income derived from the same country*". So, in what concerns the international taxation of Portuguese investment funds the legislator went further comparing to what is established in the CITC expressly mentioning that Portugal follows a per item as well as per country limitation, thereby restraining the possibilities to mix in the credit different types of income as well as the tax paid in high tax countries with the tax paid in low tax countries. Although not foreseen in the CITC it is foreseeable that the tax authorities' understanding is that this double limitation should apply not only to investment funds, but also more generally. Needless to say that this double limitation seriously narrow the virtuosities that would otherwise come to the taxpayer from the ordinary foreign tax credit method in order to

[32] Available for consultation purposes at http://info.portaldasfinancas.gov.pt and translated by WILLIAM CUNNINGHAM. As of 2005 the excess foreign tax credits are not allowed to be carried forward to be used in the following years. For the history of the wording of this article since 1989, see PRAZERES LOUSA, "Portugal", *Key practical issues to eliminate double taxation of business income*, cahiers de droit fiscal international, Vol. 96b, IFA, 2011, pp. 542-543. In the words of PRAZERES LOUSA, Portugal "*allows the taxpayer to credit the tax paid on the foreign income against the domestic tax due on the worldwide income, but the deduction must not exceed that part of domestic income tax as computed before the deduction is given corresponding to the foreign net income*", *op. cit.*, p. 541. Specifically in relation to the amendments made in 2005 and the introduction of the phrase "*net of costs or losses incurred directly or indirectly in obtaining it*", see RUI CAMACHO PALMA, *The Paradox of Gross Taxation at Source*, 38 Intertax 12, 2010, p. 636.

avoid international juridical double taxation ([33]). Moreover, this double limitation may lead to serious conflicts of qualification and unrelieved double taxation ([34]).

As it can be ascertained from the legal rules quoted above, the law is relatively scarce in details and does not provide any guidance on how to deal with certain situations. In particular it does not explain how the foreign net income should be computed according to domestic rules, namely it does not provide any criteria to determine what should be considered expenses directly and indirectly incurred to obtain the foreign income. Although it seems that all corporate expenses are relevant for these purposes (in effect more expenses means less profit and consequently less credit to be granted), it is not clear how indirect expenses incurred for the obtainment of foreign income from different sources are to be considered ([35]).

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[33] See Alberto Xavier, *op. cit.*, p. 748 and ff.

[34] According to PRAZERES LOUSA (p. 548) "*the legal provisions of domestic law are not very clear on how to calculate the limits of foreign tax eligible for deduction in cases where the same resident entity derives in the same tax year income from sources located in different jurisdictions and/or receives income from different categories. Although no guidance from tax authorities has been disclosed in this respect, according to the reporter's interpretation of the law, it is believed that, with reference to each taxation period, the procedures to be followed in calculating the tax credit would require making first a segregation of net income that has been taxed per source country, followed by a segregation of income by nature or category, without, however, rendering income autonomous per operation.*"

[35] According to PRAZERES LOUSA, *op. cit.*, (p. 546) the allocation of expenses to income from services, movable and immovable property and royalties is not difficult to make. However, in what concerns the expenses directly or indirectly related with the obtainment of interest, dividends and capital gains it may be harder to make the allocation. As the Author states "*with regard to interest from abroad, either as compensation for loans or financial investments, if it is not possible to identify the interest associated with such operations, the calculation of an average rate of interest incurred in fundraising in each taxable period may be used. When foreign income is dividends or capital gains on securities, in general the allocation of expenses incurred creates special difficulties, because there is not always a direct connection between the expenses incurred and income. However, all identifiable costs related both to the management of corporate rights and to financing costs should be imputed against such*

Although we have no knowledge of a conflict between the tax authorities and the taxpayers in this matter, we admit that a conflict in this area would be precisely the opposite to the normal conflicts between the taxpayers and the tax authorities in what concerns corporate income tax, i.e. instead of having the tax authorities challenging the deductibility of certain costs, in this case we would have the taxpayer arguing that certain costs were not connected with the attainment of the foreign income in order to obtain more net income and therefore more foreign tax credit.

A critic that is often appointed to the credit method is that it may lead to situations of unrelieved double taxation where there is a conflict of qualification of the income between the source country and the residence country and there is a DTC in force ([36]). This may happen for instance with income related with services and technical assistance where there is no permanent establishment in the source country. In fact, according to the generality of the DTCs signed by Portugal these types of income may fall under article 7 ("Business Profits"), article 12 ("Royalties") or article 14 ("Independent Personal Services") of the applicable DTC. Although the OECD considers that in certain situations of conflicts of qualification, namely in what concerns differences in domestic law classifications, the residence state still should grant relief from double taxation as the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source, the relief should not be granted in cases where the conflict derives from differences in

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income". According to a binding rule issued in 2010 (file no. 2264/10) the tax authorities expressed the opinion that when it is not possible to make a direct allocation of expenses, such as in cases of common expenses, the allocation should be made according to a rational and consistent criterion, being accepted, for instance, an apportionment formula that takes into consideration the turnover, direct expenses or tangible property.

[36] For further developments see paragraph 32.1 and ff. of the Commentary to Article 23 A and 23 B of the OECD Model Tax Convention (2010).

treaty application to facts or in the interpretation of the treaty rules. In the latter cases, the competent authorities shall endeavor efforts to resolve the conflict through the mutual agreement procedure foreseen in the DTC, otherwise the taxpayer will be subject to double taxation.

Although it is understandable that Portugal should not be obliged to relieve double taxation that occurs because the source state is taxing in violation of the treaty, this will lead to the result that the Portuguese taxpayer happens to be in a worse situation than if Portugal had not concluded a DTC with that country because in that situation the domestic rule to relieve double taxation would always apply. We consider that in these situations (in the situations where it is patent that the source state is violating the DTC) either Portugal should terminate the treaty (to have a treaty that is not complied with by the other party is better not to have the treaty at all) or, in any case, relieve double taxation by the application of the domestic rule, so that the taxpayer does not become in a worse position than another Portuguese taxpayer that obtains income in a source country with whom Portugal has not concluded a DTC.

In what concerns the diagnoses of the difficulties related with the application of the credit method in Portugal, one has also to mention the problems related with temporal mismatches in the recognition of taxable income between the source country and Portugal.

As Prazeres Lousa puts it: "*the general guidance followed by Portuguese tax authorities seems to be dictated by the concern to comply strictly with the statutory requirement that the tax credit must be exercised in the taxation period in which income from foreign sources is included in the taxable base of the resident entity. Accordingly, the recommended procedures state as follows: (a) if receipt of income and payment of tax (by withholding at source or directly) occur until the deadline for*

submission of a tax return regarding the previous taxation year, the corresponding values (of both income and tax) must be included in such tax return or replace it, within the required period of time; (b) if payment of income and tax occurs at a later date than the deadline for submission of the tax return of the tax period in which the foreign income was allocated, the taxpayer must lodge a claim graciously against the self-assessment for tax periods to which the income is related, requesting the deduction of tax paid abroad as legally allowed." ([37]).

Another issue that the law does not clarify is whether in the exercise of comparing the Portuguese tax due on the income obtained abroad, it should be considered the nominal corporate income tax, or that rate and additional surtaxes (the "*derrama municipal*" and the "*derrama estadual*") ([38]), or even the effective corporate income tax rate of the taxpayer (that can be higher or lower than the nominal tax rate depending on exemptions, autonomous taxation, etc.) ([39]).

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[37] See PRAZERES LOUSA, ob. cit., pp. 548-549.

[38] In the case of the "*derrama municipal*" considering the maximum rate established by law (1,5%) or the rate that is fixed by the municipality where the company has its head office? And if the company has permanent establishments in different municipalities? Considering that the "*derrama municipal"* (as well as autonomous taxation) should be included in the amount of credit available when there is a DTC in force with the source state, see MIGUEL LEÓNIDAS ROCHA and RICARDO JORGE ALMEIDA, *O mecanismo da eliminação da dupla tributação jurídica internacional – particularidades*, 2 Revista de Finanças Públicas e Direito Fiscal 3, 2009, p. 262 and ff. After the publication of this article the tax authorities issued a binding ruling (file n. 2264/10) in which, at least in what concerns the application of the foreign tax credit to profits of a foreign permanent establishment it admits the consideration of the "*derrama municipal"* in the CIT due on the foreign profits in the proportion of the taxable profit attributable to the said permanent establishment. Considering that the "*derrama estadual"* paid should also be considered in the fraction of the corporate income tax due in Portugal on the foreign income, ANTÓNIO FERNANDES DE OLIVEIRA, *Natureza jurídico-fiscal da colecta produzida pela denominada "derrama estadual"*, Fiscalidade 48, 2011, p. 31.

[39] Certain expenses, even if deductible to the income, are subject to an autonomous tax foreseen in the CITC which may increase the effective CIT rate.

Doubts may arise in relation to gratuitous increases in equity obtained by Portuguese resident corporate bodies mainly if the tax event is taxed in the source under a tax not similar to the Portuguese CIT (for instance tax on donations and other gratuitous acquisitions). In this case, in principle, the Portuguese resident corporation is not entitled to credit the tax suffered in the source State and double taxation will become unrelieved. In our opinion, if the computation rules of the source tax are similar to the computation rules applicable to gratuitous acquisitions by corporate entities in Portugal (article 21(2) of the CITC), although the source tax is not a tax on income and therefore a tax not similar to the Portuguese CIT, the Portuguese corporation should be entitled to the credit for the foreign tax.

Another issue not dealt with in the law, is when the corporate income tax law of the state where the foreign permanent establishment is located has a tax similar to the autonomous taxes on certain expenses foreseen in article 88 of the CITC. In this case, the tax suffered on certain expenses in the permanent establishment's State may also be credited against the Portuguese CIT on the permanent establishment profits? The double taxation is evident if the same expenses are also subject to tax in Portugal. At least literally, the wording of the law does not exclude the application of the credit in this situation.

In case of transparent entities certain difficulties may arise by the application of the credit method. According to Portuguese law credit for international juridical double taxation should be used by shareholders *pro rata* to their participation in the transparent entity although in this case there is a mismatch between the person that suffered the tax in the foreign jurisdiction and the person that is entitled to the credit in Portugal. In case the shareholders of the transparent entity are individuals, additional difficulties may arise in the computation of the limit of the credit to be

granted. In effect, besides the rules for the computation of the Portuguese PIT on the income may differ substantially from the rules from the source state, there is also the problem related with the personal income tax due in relation to the foreign source income that due to the progressive personal income tax rate will depend on the remaining income of the resident individual (low tax rates to individuals with low income and very high tax rates to individuals with high incomes).

In this respect it would be interesting to see how the Portuguese tax authorities would deal with a situation similar to the one dealt with in a United States case from 1959 (*Abbott Laboratories International Co*) ([40]). In this case, Abbott, a United States corporation, ought a credit for taxes paid to the governments of Colombia and Argentina related with subsidiaries located in those jurisdictions. Under Colombian and Argentine law the subsidiaries were tax transparent. Abbott argued that because it was liable for the taxes under foreign law, it should be entitled to a direct foreign tax credit. However, the United States court dismissed Abbott arguments and denied the credit based on the fact that the tax paid in those jurisdictions were paid out of the undistributed profits of the subsidiaries and not from distributions made by the subsidiaries. In this case, at least theoretically, it can be defended that there should have been a deferral of the foreign tax credit until the income was later distributed to the shareholder ([41]).

Another situation would be the case in which a Portuguese entity that receives income from foreign sources is disregarded as an entity in the foreign jurisdiction (the so-called reverse hybrid entities), meaning that in those jurisdictions the persons liable to

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[40] For further details see PETER M. DAUB and others, *Foreign Tax Credit Splitters – Temporary and Final Regulations Part 1*, 23 Journal of International Taxation 6, June 2012, Thomson Reuters, p. 44.

[41] In the same vein, in a scholar case similar to the Abbott case, see PHILIP R. WEST and others, *Key Practical Issues To Eliminate Double Taxation of Business Income*, 66 Bulletin for International Taxation 7, 2012, Journals IBFD, p. 349, section 5.4.

tax are the shareholders of the Portuguese entity. In this case who would be entitled to the foreign tax credit, the Portuguese entity or its shareholders (assuming that they were also resident in Portugal)?

A situation where at least *prima facie* the credit granted by Portuguese CIT law may be higher than the tax paid in Portugal is in what concerns international double taxation of capital gains. As explained, in determining the amount of credit available for the tax paid in the other State, one has to compute the fraction of the corporate income tax that is due on that income in Portugal. However, in case of capital gains, it may happen that the tax actually paid on the capital gain is half of the tax that would have been due. This is because of the reinvestment regime foreseen in article 48 of the CITC (if the price received on the sale is reinvested in the acquisition of other assets the capital gain is only considered in half). In this matter the law is not clear whether for the purposes of the limitation of the credit available, the taxpayer shall consider the Portuguese tax due on the capital gain or the Portuguese tax that actually will be paid because the taxpayer is going to reinvest the proceeds of the sale in the acquisition of new assets.

Another situation that is doubtful is the case of a corporation resident in Portugal, which has a permanent establishment located in another State that derives income from sources located in a third country. In this case, if the source country charges tax on the income and the permanent establishment state domestic law relieves double taxation of such income following the ECJ doctrine in *Saint Gobain*, should Portugal give credit for the tax paid in the permanent establishment's State and for the tax paid in the third country or only for the tax paid in the permanent establishment's State? In our opinion, as the objective of this regime is to eliminate double taxation, Portugal

should only give credit for the tax suffered in the third country in case the permanent establishment state did not eliminate completely the double taxation ([42]).

b) Economic double taxation

In a cross-border situation and in what concerns dividends received by legal persons resident in Portugal ([43]), one has to draw a distinction between dividends received from subsidiaries located in other Member States of the EU or of the European Economic Area ("EEA") (provided, in this case, that the State of residence of the subsidiary is obliged to administrative cooperation in tax matters similar to the existent within the EU) and dividends received from third countries.

In the former case, to benefit from the participation exemption the parent and the subsidiary must accomplish with the requirements set forth in Article 2 of Council Directive 2003/123/CE on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States ("Directive 2003/123/CE").

In the latter case, economic double taxation is not relieved, except for what has been agreed with the source state in a DTC and for dividends received from the former Portuguese African colonies and East Timor. In this case article 42 of the Tax Incentives Statute establishes an exemption provided the subsidiaries in those jurisdictions are subject and not exempt from a tax similar to the Portuguese CIT, the Portuguese entity has a direct shareholding of at least 25% for a period of 2 years, and the dividends derive from profits that were subject to tax at a rate of not less than 10%

[42] For further examples of triangular situations in this regard see PHILIP R. WEST and others, *op. cit*., p. 349, section 5.4.

[43] The same regime applies to permanent establishments located in Portugal of non-resident corporations as the taxation of permanent establishments follows essentially the same rules provided for resident corporations.

and do not result from activities that generate passive income, such as royalties, capital gains and other income related with securities, income from immovable property located outside the state of residence of the subsidiary, income from the insurance activity originated predominantly from assets located outside the state of residence of the subsidiary, insurance related with persons that are not resident in that territory and income from banking activities not related with the market of that territory.

In what concerns individuals, the same rules mentioned above in the domestic scenario apply to dividends received from other Member States of the EU and, in what concerns, dividends received from third States, the same rules also apply, except for the 50% relief that is not available.

In conclusion, in cases where Portuguese law foresees mechanisms to eliminate (totally or partially), international economic double taxation, it clearly follows the exemption system. And, deriving from the adoption of this system, it follows that in situations where economic double taxation is eliminated there is no juridical double taxation (being that the opposite is not necessarily true, i.e. in situations where juridical double taxation is eliminated, it can still subsist economic double taxation).

Finally, in this matter it is noteworthy mention that the Portuguese regulation on transfer pricing has specific rules (articles 17 to 22 of Ordinance 1446-C/2001, of 21 December) to deal with international economic double taxation deriving from transfer pricing adjustments made by the other State. Under certain conditions (namely the proof by the taxpayer of the double taxation situation and acceptation by the other State of the consultation process under the mutual agreement procedure or the arbitration procedure), the Portuguese tax authorities make the correlative adjustment

within 120 days after the agreement obtained with the tax authorities of the other State and shall reimburse any excess tax within 90 days after the agreement is obtained.

4. The avoidance of international double taxation under the double taxation conventions signed by Portugal

For the comparison of the relevant article of the 64 DTCs signed by Portugal with the OECD Model tax Convention, we will separate them in three different groups: the first group is formed by Austria alone, the second group is formed by the DTCs where the provision for the elimination of international juridical double taxation is identical to Article 23-B of the OECD Model Tax Convention and, finally, the third group where we can find deviations from Article 23-B of the OECD Model Tax Convention.

Austria appears alone in the first group because it is the only case where Portugal adopted the exemption with progression method for business income and the ordinary credit for passive income (dividends, interest and royalties) ([44]).

The second group is in majority, and it is formed by the DTCs signed with Barbados, Bulgaria, Canada, Colombia, Czech Republic, Denmark, France, East Timor, Estonia, Finland, Germany, Guinea Bissau, Hong Kong, Hungary, Indonesia, Ireland, Iceland, Italy, Latvia, Lithuania, Moldavia, Morocco, Norway, Panama, Poland, Qatar,

[44] In the words of MAISTO "*an interesting case is that of the double taxation convention between Portugal and Austria. Portugal (which has a credit treaty policy) agreed upon the exemption method, except for dividends, interest and royalties. Austria did the same. Such an exception may likely be due to the bargaining between Portugal and Austria: Portugal likely agreed to the exemption to the extent that Austria included a tax sparing credit clause to be applied with regard to certain dividends, interest and royalties. (Which it did). On the other hand, the reason why Austria agreed to a unilateral tax sparing provision in favour of Portugal likely was a historical one and designed to promote Austrian investments in Portugal*", *op. cit.* p. 352.

Romania, Russia, Singapore, Slovakia, Slovenia, South Africa, Sweden, Switzerland, Ukraine, United Arab Emirates, Uruguay and Venezuela ([45]).

The last group of DTCs is formed by a set of rules that have one characteristic in common. They all, in essence, follow the pattern of article 23-B of the OECD Model Tax Convention. However, in this last group and in different forms, we assist to clauses that go beyond what it is established in the OECD Model Convention.

This is the case of the DTCs signed with Algeria, Cape Verde, China, South Korea, Cuba, India, Malta, Mozambique and Tunisia that contain some form of tax sparing clauses granted by Portugal (or by both Contracting States) ([46]).

In the case of the DTCs signed with Belgium, Brazil, Chile, Greece, Israel, Japan, Luxembourg, Macao, Mexico, Spain, Tunisia, Turkey and the United States, they all

[45] The DTCs with Finland and Switzerland do not have the rule of Article 23-B(2) of the OECD Model Convention that establishes that "*where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital*" (the DTC in force with Italy has this clause but only in the Protocol). According to paragraph 79 of the Commentary to Article 23 A and 23 B of the OECD Model Tax Convention (2010) this paragraph has been added to enable the State of residence to retain the right to take the amount of income exempted in that State into consideration when determining the tax to be imposed on the rest of the income, thus safeguarding the principle of progression in the State of residence. Although present in the remaining DTCs and although the Portuguese Personal Income Tax Code (article 22(4)(7)) establishes rules for computing these cases of exemption with progression, this provision is currently not relevant from a Portuguese perspective as to the best of our knowledge there are no cases of exemption with progression in Portuguese Tax Law, except for the special regime available for non-habitual residents.

[46] For a critical perspective to the effectiveness of tax sparing provisions, see MORVAN MEIRELLES, *Tax Sparing Credits in Tax Treaties: The Future and the Effect on EC Law*, 49 European Taxation 5, 2009, p. 263 and ff.

establish some sort of elimination of international economic double taxation. In the cases of the DTCs entered into with Belgium, Greece, Luxembourg and Spain these clauses that grant a deduction of 95% of the dividends received by Portuguese parent companies with a minimum direct holding of 25% are now almost obsolete because of the application of domestic rules that implement the Parent Subsidiary Directive in relation to the payment of dividends between parent companies and subsidiaries in different Member States of the EU that only requires a minimum direct holding of 10% held uninterruptedly for 1 year and that establishes full exemption (that operates through a 100% deduction to the taxable profit) ([47]). Therefore in relation to these DTCs, it may be argued that only for the cases where there is a distribution of dividends before the 1 year requirement is met and that is not going to be met subsequently ([48]) the elimination of economic double taxation in the DTC will apply (as in these DTCs the minimum holding period requirement is not expressly mentioned). In any case, it cannot be discarded the possibility that the phrase "in the terms and conditions established in Portuguese law" mentioned in the clauses may be considered by the tax authorities as a reference to the 1 year holding requirement foreseen in domestic law, case in which these clauses of the DTCs have to be considered completely obsolete.

[47] In these cases the DTCs further mention that the elimination of economic double taxation is made "in the terms and conditions established in Portuguese law". These DTCs were all signed before 2000 when Portuguese foresaw a 95% deduction. This 95% was replaced by a 100% deduction in the beginning of 2001. Therefore the question is whether it should be considered that the 95% deduction should be considered tacitly replaced by a 100% deduction or if it remains 95%.

[48] According to Portuguese domestic law that implements the Parent Subsidiary Directive a Portuguese parent company may meet the 1year minimum holding requirement after the dividends are distributed.

In the DTCs signed with Brazil, Israel and Turkey, in order to benefit from a deduction of 95% of the dividends received, the Portuguese parent company ([49]) must hold a direct participation of at least 25% in the Brazilian, Israelite or Turkish company (subject to tax and not covered by any exemption) and the participation has to have been held uninterruptedly in the two years prior to the distribution or since the incorporation of the Brazilian, Israelite or Turkish company, but in this case also only if the participation is held uninterruptedly for 2 years ([50])([51]). The same is true for the DTC signed with Chile but in this case Portugal allows a full deduction of the dividends.

The DTC signed with Japan is more liberal in the requirements as instead of the 25% minimum holding for an uninterrupted period of two years it only requires a 10% minimum holding held for an uninterrupted period of 1 year but requiring that the profits out of which the dividends are paid are effectively taxed at a rate of at least 10% ([52]).

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[49] In case of Israel and Turkey the rule does not apply to Portuguese partnerships.

[50] In the DTC signed with Turkey and face to the wording of the clause it is not clear that in case the Turkish subsidiary was incorporated less than two years ago the participation has to be kept uninterruptedly for that period in order to benefit from the deduction.

[51] The Protocol of the DTC signed with Brazil further mentions that in case Portugal changes the method to eliminate the economic double taxation of foreign dividends presently foreseen in Portuguese law by the indirect credit method, this method will apply automatically to dividends paid by Brazilian companies to Portuguese companies. This wording may lead to misinterpretations as Portugal does not eliminate economic double taxation of foreign dividends, besides the cases covered by the Parent Subsidiary Directive and the former African colonies.

[52] For further developments on the concept of effectively taxed see FRANCISCO DE SOUSA DA CÂMARA and BRUNO SANTIAGO, *O "novo" regime de eliminação da dupla tributação económica dos lucros distribuídos: o artigo 51.º, n.º 10, do Código do IRC*, Estudos em Memória do Prof. Doutor J. L. Saldanha Sanches, Vol. IV, Coimbra Editora, Coimbra, 2011.

It is noteworthy mentioning that in the DTCs signed with Mexico and the United States it is foreseen a clause similar to the clause described above in relation to Brazil, Israel and Turkey but with one difference. While in the formers the 95% deduction may be granted prior to the verification of the two years holding requirement if the subsidiary was incorporated less than two years before the dividends are distributed, in the case of the latter DTCs the deduction may be granted in case the Portuguese parent company was incorporated less than two years ago (in any case the holding period has to be met subsequently).

What happens in relation to Mexico and the United States is also true for the DTC signed with Macao but in this case in order to benefit from the 95% deduction it is also required that the main activity effectively performed by the subsidiary in Macao consists in air transport or, in case of industry related with the production and distribution of electricity, gas, water, construction, accommodation and restaurants, such activities are located predominately in Macao.

Finally, in the case of Tunisia, the DTC is not clear. First, it establishes that the elimination of double taxation includes any tax that would have been paid in the source state if it were not exempt, deducted or temporarily reduced due to the application of the law in the source state. In any case this tax sparing shall not exceed the amount corresponding to the application of a rate of 15% to the dividends received. Afterwards, it establishes that this tax-sparing regime does not apply to dividends paid by a company resident in Tunisia to a company resident in Portugal while the Portuguese company benefits from the deduction to the taxable base of 95% of those dividends, in accordance with Portuguese law. According to our interpretation of this poorly written rule it can be concluded that it establishes the elimination of economic double taxation (95%), in relation to dividends distributed by a subsidiary in Tunisia to a company resident in Portugal, at least while domestic law

provided for a deduction of 95% of the dividends received from domestic subsidiaries. This is because what the provision states is that the tax sparing clause in relation to dividends distributed by a company in Tunisia (article 22(b) first paragraph) does not apply while the Portuguese company is entitled to eliminate economic double taxation of the dividends received from Tunisia. If Portuguese law is changed and the participation exemption for dividends ceases to apply, then Portugal will begin eliminating juridical double taxation on the dividends even if the dividends are not taxed in Tunisia (i.e. granting a tax sparing).

The 95% deduction was in force when this DTC was signed and was kept in domestic law until the end of 2000 being then replaced by an identical but more favorable regime as it grants a full deduction of the dividends. Therefore it can be questioned if this replacement occurred in the end of 2000 means that the regime is no longer in force and therefore the Portuguese parent company may no longer benefit from the elimination of economic double taxation. In our understanding the Portuguese parent company may continue to benefit from the elimination of economic double taxation in relation to dividends received from Tunisia as the reasoning underlying this rule was to cease the availability of the rule to eliminate economic double taxation in case that rule ceased to apply in Portuguese domestic law. But the rule did not disappear from Portuguese domestic law, it was just reaffirmed with a 100% deduction.

The DTCs with Belgium, Greece, India, Kuwait, Pakistan and Spain, although with not entirely coincident wordings, mention directly or indirectly that the provisions of domestic law shall continue to govern on the elimination international juridical double taxation except if against the principles of the DTC. In our opinion the reason for this wording can be found in paragraph 60 of the Commentary to Article 23 A and 23 B of the OECD Model Tax Convention (2010) that mentions "*in many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of*

conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23 B". In other words, the wordings in these DTCs corroborate Prazeres Lousa when the Author mentions that "*there is interaction between the provisions of domestic law and those of DTCs governing the tax credit as far as calculation rules and the way in which the deduction of foreign tax operates are concerned*" ([53]). However, in our opinion, domestic law does not go much further than the DTC already provide for and more domestic detailed rules would be desirable in this respect.

The DTC with the Netherlands has a particular provision that establishes that "*where a resident of Portugal receives a payment or lump sum which may be taxed in the Netherlands in accordance with paragraph 3 of article 18, the Netherlands shall allow a deduction from its tax on such payment or lump sum to an amount equal to the tax levied in Portugal on the said payment or lump sum*". In this very interesting provision we assist a sort of elimination of double taxation by the source state which is rather uncommon.

We end this chapter with two final brief notes in relation to the DTCs signed with two Anglo Saxon countries. First to mention that in the DTC with the United States it is also established that Portugal does not grant the ordinary credit in case the tax paid in the United States is due by virtue of the citizenship which means that a United States citizen resident in Portugal and that is taxed in the United States by virtue of its citizenship is in fact subject to double taxation ([54]). Finally, the DTC signed with the

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[53] *Op. cit.*, p. 543.

[54] For further developments on US taxation based on nationality see PAUL MCDANIEL, HUGH AULT, JAMES REPETTI, *Introduction to United States International Taxation*, Fifth edition, Kluwer Law International.

United Kingdom in 1968 and that is still in force has a very interesting provision (article 22(4)) regarding transfer pricing adjustments and the obligation to grant credit in relation to the tax paid by virtue of the adjustment ([55]).

[55] This article has also a rule for the allocation of income derived from personal services including liberal professions and income derived by individuals rendering services in ships and aircrafts. Furthermore, this DTC (and the DTC with France) provide for what ALBERTO XAVIER names the double limit clause, i.e., besides the credit may not be higher than the fraction of the CIT, computed before the credit, which corresponds to the income taxed in the source country, it also cannot exceed the fraction of the tax in the source state corresponding to the part of the income taxed in the residence state, *op. cit.*, p. 750.

CHAPTER III: COMPARATIVE SURVEY WITH THE SYSTEMS ADOPTED IN OTHER MAJOR JURISDICTIONS ([56])

In this chapter we will make a brief comparative analysis with the systems to eliminate international economic and juridical double taxation of corporations in force in other five major European jurisdictions (Spain, France, Germany, United Kingdom and the Netherlands) and in the United States. As a preliminary remark it is worth mentioning that generally the countries surveyed do not follow a pure exemption or credit system, often combining both systems. Due to the aim of this chapter – to provide an overview of the systems followed in jurisdictions of reference to get an overall picture of different alternatives available – we will not go into the details and subtleties of each system.

Spain employs two methods to avoid double taxation of foreign source income: the exemption and the ordinary credit method. Generally, the taxpayer may choose one of these two methods to eliminate double taxation, except for certain cases where the credit method is mandatory. Profits attributable to permanent establishments abroad are exempt if they were subject to tax in the permanent establishment state and at least 85% of that profit has been derived from the performance of business activities. If the head office has previously deducted losses from a permanent establishment, the exemption applies only to the profit exceeding such deduction.

The participation exemption is available for dividends derived from qualified (5%) non-resident subsidiaries.

([56]) In what concerns the European countries the information was collected in the *European Tax Handbook*, 2012, IBFD and in Staff of the Joint Committee on Taxation, *Background and selected issues related to the U.S. International Tax System and Systems that Exempt Foreign Business Income*, May 20 2011, JCX- 33-11.

In France ([57]), foreign business income of resident companies (including income attributable to a permanent establishment of a resident company) is taxed in accordance with the principle of territoriality. Nevertheless income from passive foreign sources, not connected with business taken place out of France, is taxed with basis on the worldwide income principle ([58]). There is no credit for foreign taxes under domestic law, but foreign taxes levied by non-treaty countries are deductible as expenses. The credit method is available to passive investment income under DTCs.
Dividends distributed by subsidiaries in other EEA Member States to resident companies, which hold a participation of at least 5% of the voting and financial rights, and which have held this participation, or commit to hold, for at least 2 years, may benefit from a 95% exemption.

In Germany ([59]), the exemption method is applicable in the case of foreign business income under the DTCs entered into by Germany. In case there is no DTC with the source state, foreign business income is subject to the ordinary credit under domestic law or, at the taxpayer's request, foreign taxes may be deducted to the taxable income in lieu of being credited against tax. Generally income from branches is exempt in Germany and losses are not deductible. In certain situations there is a switch from exemption to the credit method to prevent tax planning.

Similarly to France, resident companies are 95% exempted of taxation in relation to the dividends received from foreign subsidiaries. Differently to the French tax regime,

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[57] *Background and selected issues related to the U.S. International Tax System and Systems that Exempt Foreign Business Income*, Scheduled for a Public Hearing before the Committee on Ways and Means on May 24, 2011, prepared by the Staff of the Joint Committee on Taxation, May 20 2011, JCX- 33-11, p. 22-24.

[58] Royalties, interest, and portfolio dividends.

[59] For further developments see JÜRGEN LÜDICKE, *Exemption and Tax Credit in German Tax Treaties – Policy and Reality*, 64 Bulletin for International Taxation 12, 2010, Journals IBFD.

that demands a 2 years holding requirement, German law does not require any minimum period and the exemption is granted regardless of the holding being substantial or not. In case the subsidiary is located in a third country (non EU), the subsidiary has to fulfill an active business test.

In United Kingdom, resident companies are taxed on their worldwide income. A company may elect for the profits attributable to its foreign permanent establishment to be exempt. Foreign losses attributable to the permanent establishment are correspondingly not deductible. International juridical double taxation is avoided by the ordinary credit method, both unilaterally and under DTCs. An election may be made to deduct the foreign tax as an expense instead of claiming credit relief. Relief by exemption may also be given for certain types of income and gains under DTCs.
Dividends received from large or medium sized foreign subsidiaries are exempted from tax. In relation to small sized companies, it is required in order to access the exemption mechanism that the company paying the dividends is located in a territory in which a DTC with a nondiscrimination clause was entered into with the United Kingdom. Whenever exemption is not applicable to dividends, credit relief for foreign taxes applies. Indirect tax credit is also available in case the resident company holds at least 10% of the voting power in the non-resident distributing company.

In the Netherlands domestic law has detailed rules for the elimination of international double taxation in different situations, but generally the exemption system applies to foreign business income. The DTCs entered into by the Netherlands provide for the exemption with progression method and a credit in the case of withholding tax on dividends, interest and royalties.

Profits from foreign permanent establishments are exempt. The exemption does not apply to passive permanent establishments that are taxed at low rates. These permanent establishments will instead receive a 5% credit.
The participation exemption applies to dividends from qualified subsidiaries.
The Netherlands also applies a residual relief method according to which when exemption or credit relief is not available, income and withholding taxes paid abroad may be deducted as expenses from the gross foreign income that is taxable in the Netherlands.

Finally, in what concerns the United States it can be generally affirmed that the system chosen by the United States to eliminate double taxation of foreign source income (active and passive) of domestic corporations is the credit system. The indirect foreign tax credit is available for United States corporations that own 10% or more of the voting rights of a foreign corporation from which they receive dividends (including lower tier subsidiaries provided certain requirements are met).

CHAPTER IV: THE ADOPTION OF THE EXEMPTION SYSTEM IN PORTUGAL

As we have seen above, Portugal, similarly to other countries, uses both the credit and the exemption method to eliminate international double taxation. Generally and notwithstanding some special cases, Portugal deploys the credit method, except for dividends from substantial holdings in companies located in other Member States of the EEA, where Portugal adopts the exemption method.

In this chapter the author will present several arguments towards the replacement of the credit method by the exemption method and will highlight some additional measures that would be required following the adoption of the exemption method, namely in order to contravene abusive practices and ensuring that the real aim of the exemption system is fulfilled, i.e. the avoidance of double taxation and not the promotion of non-taxation ([60]).

Although the author is primarily concerned with active income (meaning income from business or entrepreneurial activities, including foreign direct investment by way of subsidiaries and branches, artists, sportsmen and employment income), there is no special reason not to include passive income (such as rents, interest, royalties and

[60] When referring to the adoption of the exemption method, we are referring to the exemption with progression as it is the most suitable to contribute to horizontal equity. Although it can be argued that the exemption method may violate the principle of equality (as it leads to unequal taxation of foreign and domestic income) as well as the ability-to-pay principle (as two taxpayers that derive the same amount of income, one exclusively from domestic sources and the other exclusively from foreign sources, will bear a different tax burden), this unequal treatment should generally be justified by the different conditions borne in the source state. It is noteworth mentioning that as far as we could ascertain in relation to countries that follow the exemption system, it was never been discussed in court an alleged violation of the equality and ability-to-pay principles as a result of the adoption of the exemption system.

portfolio dividends ([61])), besides, of course, the need to ensure that there is not an unaffordable loss of tax revenue.

In Portugal, investors, companies and workers in many cases due to the stagnation (if not retraction) of domestic consumption have no further options besides looking (and moving) into other markets in order to be able to sell their products, services and skills.

Due to this reality and the perceived incapacity of the Government to override the stagnation of domestic consumption due to the need to implement austerity measures to reduce the public deficit, it should, at least, be able to remove barriers to the economic agents that are willing to go abroad.

Moreover, although an escalation of the investment abroad will not contribute to an increase of the gross domestic product ("GDP") (that in any case will never occur because of the reduction in domestic consumption), it will certainly contribute to promote the gross national income ("GNI") and the gross national product ("GNP"). And notwithstanding the need to reverse the trend in what concerns the Portuguese GDP, the positives outcomes on the GNI and GNP derived from investments abroad should not be underestimated for that goal. In effect, measures to increase GNI and GNP in the medium-term will lead to an increase of the capital available, which can promote domestic investment, as well as, consumption with a positive impact in the GDP ([62]).

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[61] See European Commission, Directorate-General Taxation and Customs Union, *Public Consultation Paper Taxation problems that arise when dividends are distributed across borders to portfolio and individual investors and possible solutions*", 28 January 2011, available at http://ec.europa.eu/taxation_customs/common/consultations/tax/2011_withholding_taxes_en.htm.

[62] OLIVIER BLANCHARD, *Macroeconomia – Teoria e Política Económica*, (MIT), tradução da 2.ª edição de Maria José Cyhlar Monteiro, Rio de Janeiro, Elsevier, 2001, 10.ª Reimpressão, p. 375 and ff..

Therefore, in the author's view it is paramount to create the conditions to invest abroad and simultaneously promoting the repatriation of the proceeds back to Portugal ([63]). The adoption of the exemption system to eliminate international juridical double taxation is a tax measure that could play a significant role in the achievement of this goal.

In effect it is commonly agreed that CIN is more suitable to promote international investment than CEN ([64]). This is not difficult to understand as in what concerns residents in a given county, the prospect of being taxed more heavily than their competitors in the destination market may, of course, influence their decision to invest abroad ([65]). Moreover the high levels of taxation in Portugal will also deter the investor to internationalize his enterprise maintaining its Portuguese head-office, except if a new method of relieving international double taxation is pursued in order to promote cross-border investment by Portuguese residents. Other authors share a similar view as it is the case of Freitas Pereira that considers that in theoretic terms

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[63] "*In Japan, the facilitation of repatriation of profits was a driving force behind the change to an exemption system in the Tax Reform 2009/2010, which was based on the concepts of neutrality regarding corporate decisions on dividend policy, maintaining adequate avoidance of double taxation and simplifying the system*", GEORG KOFLER, *op. cit.* p. 83.

[64] See, for instance, THOMAS HORST, *Note on the optimal Taxation of International Investment Income*, 94 the Quarterly Journal of Economics, 1980, quoted by Vogel, *supra* note 3.

[65] In the words of ERIC KEMMEREN "*residents of high-tax (or higher-tax) states will be deterred from investing in low-tax states, because the residents of the low or lower-tax states who earn a higher after-tax return will have a competitive advantage. The allocation of tax jurisdiction on the basis of the territoriality principle should therefore be favoured. It enables enterprises to compete on a level playing field with their foreign competitors*", *Legal and Economic Principles Support an Origin and Import Neutrality-Based over a Residence and Export Neutrality-Based Tax Treaty Policy*, in MICHAEL LANG, PASQUALE PISTONE, JOSEF SCHUCH, CLAUS STARINGER, ALFRED STORCK, MARTIN ZAGLER (eds.), Tax Treaties: Building Bridges between Law and Economics, IBFD, 2010, P. 295.

CEN is not preferable to CIN and, specifically in relation to Portugal, a capital import country, CIN is the most suitable option ([66]). This author further argues that in a context of internationalization of Portuguese companies it should be weighted the extension of the exemption system to profits distributed by foreign subsidiaries (outside the EU) and replacing the exemption by a (indirect and direct) credit system in cases the non-resident subsidiaries are established in low-tax countries ([67]).

Another argument in favor of the adoption of the exemption system in Portugal is that the credit system creates a disparity between the ways the investment abroad is made. In the credit method, if the investor chooses to open a subsidiary in the source country it will not be taxed in Portugal until the profits are repatriated in the form of dividends; however, if it chooses to invest directly or through a permanent establishment the deferral of profits will not be possible and it will be immediately taxed because of the world-wide basis of taxation. And the inconsistency of the credit system can also be perceived by the fact that from a tax point of view and according to the above, it would be preferable to invest through a subsidiary. Nevertheless, the inexistence of an indirect foreign tax credit in Portuguese law goes in the direction of creating a bias towards the investment through permanent establishments to avoid double taxation that arises when using foreign subsidiaries in the absence of an indirect foreign tax credit ([68]).

Furthermore, indirectly and taking into account the international trend towards exemption including in rich industrialized countries that are the principal foreign

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[66] Also defending the adoption of CIN at the EU level, see ANA PAULA DOURADO, *A Tributação dos Rendimentos de Capitais: A Harmonização na Comunidade Europeia*, Cadernos de Ciência e Técnica Fiscal, CEF, Lisboa, 1996, p. 289.

[67] M. H. FREITAS PEREIRA, *Tributação das Sociedades e Globalização Económica*, Ciência e Técnica Fiscal 422, 2008, p. 17 and 23.

[68] In the same vein RICHARD VANN, *op. cit.* p. 40.

investors ([69]), the alignment of our tax law with the exemption system may contribute to create the idea that if the foreign investor chooses to invest in Portugal it will bear the same tax as if it were a domestic investor.

However, the adoption of the exemption method in domestic Portuguese law could not be made without first dealing with some thorn in the flesh, the first of all being the fact that all of the DTCs signed by Portugal (except the one with Austria) adopted a provision for the elimination of international juridical double taxation identical to article 23-B of the OECD Model Tax Convention. This could raise some constraints, at least for those who consider that international conventions rank *pari passu* with domestic law and, therefore, as *lex posterior priori derogat*, the change in the domestic system would amount to a treaty override or, for those who consider that international conventions rank higher than domestic law, it would mean that the change in domestic law would in practice be meaningless as the majority of our foreign investment (except for Angola) is made with DTC partners.

In our perspective this difficulty will be in practice and to a great extent a non-issue because DTCs may not impose a higher tax burden than under domestic law. Therefore, in case there is an exemption in domestic law, the DTCs may not provide the state of residence with taxing powers to subject the foreign income to tax and then grant a tax credit ([70]). In any case, a suitable alternative could consist in Portugal

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([69]) According to Professor GEORG KOFLER "*there is an international trend towards exempting profits distributed by foreign subsidiaries at the level of the parent company, with the main reasons for this trend being an increase in the competitiveness of domestic tax systems, simplicity and consistency with recent international developments. Currently, 26 out of the 34 OECD Member countries have territorial tax systems, and alone in 2009 Japan, New Zealand, and the United Kingdom have moved towards exemption*", *op. cit.* p. 89.

([70]) This is what GUGLIEMO MAISTO calls the principle of non-aggravation by tax treaties, *op. cit*. p. 357. In the same vein, MANUEL PIRES, *op. cit*, p. 361.

assessing with its treaty partners of their willingness to accept an addenda to the DTCs just in what concerns the method for elimination of double taxation followed by Portugal.

In adopting the exemption system special attention should be drawn to the situation of permanent establishments. As a rule it would be normal that as the profits of the permanent establishment are exempt, the losses should not be deducted in the residence state. However, in our opinion, lessons should be taken from recent case law of the ECJ in this regard ([71]) in order to achieve a solution that relieves double taxation to the largest extent possible and is compatible with the fundamental freedoms as interpreted by the case law of the European Court. In this regard, ultimately if losses cannot be deducted in the home state neither in the permanent establishment, it can be argued that the home state is discriminating foreign permanent establishments against domestic permanent establishments as the latter may deduct their losses against the profitable parts of the remaining of the enterprise.
Besides this more extreme hypothetical situation, there are a variety of other situations that we could think of and that are not easy to deal with in a manner that presumably is compatible with EU Law. In any case, to try to avoid infringement procedures in this regard, it should be considered the possibility of deducting losses of the foreign permanent establishment of a resident entity (as well as foreign losses of a local permanent establishment of a non-resident entity), even if those losses may be carried forward in the permanent establishment state, combined with a recapture mechanism according to which when the permanent establishment starts deriving

[71] See ECJ, 28 February 2008, Case C-293/06, *Deutsche Shell GmbH v. Finanzamt fur Grossunternehmen in Hamburg*; ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronn*; ECJ, 23 October 2008, Case C-157/07, *Krankenheim Ruhesitz and Wannsee-Seniorenheimstatt GmbH v. Finanzamt für Körperschaften III in Berlim*.

profits those profits are taxed in the home state up until the amount of losses deducted ([72]).

Finally, it is our understanding that the incorporation of the exemption system into domestic law could not be made without some sort of anti-avoidance mechanisms to circumvent some undesired effects that can result of the adoption of this method for the avoidance of double taxation.

The first observation that immediately catches the eye of the most distracted observer is that if by any reason the income is not taxed in the source state, the adoption of the exemption method by the residence will tantamount to non-taxation ([73]).

To avoid this undesirable effect, it is common for countries that follow the exemption method to incorporate some sort of switch-over clauses ([74]), foreseeing a switch from the exemption method to the credit method in specific situations aiming at discouraging inflow of revenues through low-tax third countries, together with the operation of other anti-avoidance rules such as CFC legislation that, in this scenario,

[72] Unless the losses cannot be offset against taxable income in the permanent establishment's state. The aim of the recapture mechanism is to avoid the multiple deduction of losses. Strongly advocating this solution see JÉRÔME MONSENEGRO, *Taxation of Foreign Business Income within the European Internal Market*, 22 Doctoral Series IBFD, 2012.

[73] In this regard, the exemption should be framed with some sort of subject to tax clause to make sure that only income that was effectively taxed in the source state is exempt in the residence state. This subject to tax clause should address issues such as the carry forward or back of losses in the source state or a minimum threshold to be considered subject to tax.

[74] For an example of such clause see the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM (2011) 121/4, C7 - 0092/2011 2011/0058 (CNS)), Brussels, article 73. The ECJ already ruled in Case C-298/05 (*Columbus Container Services B.V.B.A & Co. v. Finanzamt Biefeld-Innenstadt*) that the switch-over from exemption to credit foreseen in German domestic tax law, despite any adverse consequences in terms of tax burden, is not in breach of EU Law.

would apply both to non-resident subsidiaries as well as to foreign permanent establishments.

It would also be important to have expense allocation rules to avoid the situation of having "profits abroad and losses at home"; i.e. mainly in relation to business income, it is important to avoid that taxpayers allocate the maximum amount of expenses to domestic income, diminishing profit in Portugal, and allocating the maximum income at the source State, that can have a more beneficial income tax rate.

In the same vein, it should also be borne in mind that interest paid by a resident taxpayer related with a loan obtained to finance the foreign activity should not be deductible. In what concerns Portuguese law this limitation already follows from the existent law as, under article 23 of the CITC, costs are only deductible in so far as they are indispensable for the attainment of income subject to tax. In any case it would advisable to create special rules in order to establish a connection between the interest borne and the foreign source income ([75]).

[75] Similarly see PRAZERES LOUSA, *O problema da dedutibilidade dos juros*, Estudos em Homenagem à Dra. Maria de Lourdes Correia e Vale, Cadernos de Ciência e Técnica Fiscal, Lisboa, CEF, 171, 1995, p. 361.

CONCLUSION

The analyses made above allow us to extract the following conclusions:

a) In world trade the interests of rich industrialized countries are not coincident with the interests of the poor, thin capitalized and unindustrialized countries. Based in these antagonist public realities, economists and public financers developed the theoretical concepts of capital export neutrality and capital import neutrality. The credit and the exemption mechanisms to eliminate international double taxation used by the different states in the world are seen as ways to pursuing one of these two different concepts in debate.

b) Portugal uses both the credit and the exemption method to eliminate international double taxation. In broad and general terms it can be affirmed that Portugal uses the credit method to eliminate international juridical double taxation, except for dividends from substantial holdings in companies located in other Member States of the EEA, where Portugal adopts the exemption method.

c) Generally the DTCs signed by Portugal follow the pattern of Article 23-B of the OECD Model Tax Convention. Certain DTCs have minor deviations to the model and in other DTCs it is also foreseen a relief of economic double taxation.

d) A comparative analysis with the systems to eliminate international double taxation of corporations in force in other five major European jurisdictions (Spain, France, Germany, United Kingdom and the Netherlands) and in the United States, allow us to conclude that generally the countries surveyed do

not follow a pure exemption or credit system and often combine these two systems, depending on the type of income considered.

e) The adoption of the exemption system to eliminate international juridical double taxation is a tax measure adequate to achieve the aim of creating better conditions to invest abroad and also to promote the repatriation of the proceeds to Portugal. Even if an escalation of the investment abroad will not contribute to an increase of the GDP in the short term, it will contribute for the promotion of GNI and GNP, which in the medium-term will enhance the capital available and in turn will promote domestic investment and consumption and, consequently, the GDP. Thus, the adoption of the exemption method is suitable to contribute to the recovery of the Portuguese economy and inflect the actual recession to a new era of economic development.

f) This Copernican revolution in what concerns the elimination of international double taxation has to be accompanied by further studies to understand to what extent it can fully or only partially implemented (namely leaving out passive income) and with specific measures to prevent situations of double non taxation.

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