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PORTUGUESE TAX ARBITRATION COURT DECISION FROM 8 APRIL 2019

Lisbon Old town | Adam Wolszczak

Capital gains individual taxation – free movement of capital – refrain from submiting question to European Court of Justice

By Pedro Nércio

According to the European Union principle of free movement of capital (Article 63 of the Treaty on the Functioning of the European Union), all restrictions on the movement of capital between Member States shall be prohibited. Thus, it results from this principle that the legislation of a member State cannot negatively discriminate a national of another member State within the process of acquisition and sale of goods and services, including the establishment of discriminatory tax regimes arising from such transactions.

As such, and for the purpose of this article, the abovementioned principle precludes the national legislation which subjects capital gains obtained by a resident of another Member State resulting from the sale of immovable property situated in a Member State, to a tax burden greater than that which would be applicable to capital gains obtained by a resident of the State in which that immovable property is situated.

Individual Taxation of Capital Gains in Portugal Until 2008

This exact situation occurred in Portugal until 2008, since the Portuguese Personal Income Tax Code ("IRS"), in force until 31 December 2007, clearly established different tax regimes for Portuguese residents and non-resident individuals. In fact, in relation to capital gains obtained with the sale of immovable property in Portugal by a Portuguese resident

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individual, IRS was only levied on 50% of the relevant amount. As regards capital gains obtained by non-resident individuals, such 50% benefit was not applicable, which means that IRS was levied on 100% of the capital gains.

The Portuguese tax authorities claimed then that the existence of different tax regimes was justified by the fact that Portuguese resident individuals were subject to progressive tax rates which could go up to 42%, whilst non-residents individuals were subject to a flat tax rate of 25%. Therefore, in the understanding of the Portuguese tax authorities, the existence of two different tax regimes was required to ensure the cohesion of the Portuguese tax system which subject Portuguese residents and non-residents to different tax assessment rules.

This situation led to European Court of Justice decision of 11 October 2007 (case C-443/06 – "Hoffman"), which considered that the taking into account of only half of the basis of capital gains obtained by a resident, together with the fact that the tax levied on that resident's income is subject to a progressive rate up to 42%, results, in the same taxable circumstances for a non-resident, in heavier taxation of the latter.

This way, according to the abovementioned decision, the tax advantage granted to residents, consisting of a reduction of half of the tax basis of capital gains, in any event outweighs the consideration for that advantage, namely, the application of a progressive rate to the taxation of their income.

As such, the European Court of Justice ruled that the restriction resulting from the Portuguese tax legislation cannot be justified by the need to ensure the cohesion of the tax system and therefore considered such legislation in breach of the principle of free movement of capital.

Individual Taxation of Capital Gains in Portugal After 2008

The abovementioned European Court of Justice decision forced Portugal to proceed to the amendment of its relevant legislation.

Consequently, in 1 January 2008, a new capital gains individual tax regime entered in force in Portugal, granting non-resident individuals the possibility of adopting the tax assessment rules applicable to Portuguese resident individuals (according to which personal income is subject to progressive rates up to 42% - Article 68 of the Personal Income Tax Code), thus benefiting from the abovementioned 50% reduction. However, in case such option is not exercised by the non-resident, capital gains are subject to a 28% tax flat rate without any reduction (Article 72.1.a) of the Personal Income Tax Code).

According to the Portuguese tax authorities, this new option allows non-resident individuals to be treated for capital gains tax purposes as Portuguese resident individuals and therefore solves the issue raised by the European Court of Justice.

Nevertheless, from our point of view, this amendment did not put an end to the discrimination of non-resident individuals in relation to the tax regime applicable to Portuguese residents regarding capital gains obtained from the sale of immovable property. In fact, on the one hand, the abovementioned option constitutes a restrain to non-residents individuals (since they need to fulfil a specific option requirement in order to get access to an equal taxation) and, on the other hand, this new rule does not solve *tout court* the existence of a different tax treatment between Portuguese residents and non-residents, in case such option is not exercised.

Portuguese Tax Arbitration Court Decision

This same position has recently been confirmed by the Portuguese Tax Arbitration Court[1], in its decision of 8 April 2019 (case no. 600/2018-T[2]), which considered that an option which allows a non-resident individual to be treated in the same terms as a Portuguese resident individual does not exclude the discriminatory effects of the regime that is applicable if such option is not exercised[3].

Moreover, according to this Portuguese Tax Arbitration Court decision, the existence of such an option would not solve the discriminatory essence of the taxation regime in question, since the rule that would be applicable in case the option would not be exercised would be clearly incompatible with the European Union principles.

In conclusion, the Portuguese Tax Arbitration Court determined that the new rule which allows non-resident individuals to opt for a taxation regime which grants them the same tax treatment as Portuguese residents in what concerns capital gains obtained from the sale of immovable property (*i.e.* taxation of only 50% of the gain) is still in breach of the European Union principle of free movement of capital, since the default regime (in case the option is not exercised) is clearly discriminatory in relation to Portuguese non-resident individuals.

Consequently, the Portuguese Tax Arbitration Court determined the annulment of the tax assessments which were issued according to the aforesaid discriminatory legislatio, thus confirming the non-compliance of the Portuguese legislation with the European Union principles.

In conclusion, taking into consideration this recent decision and others issued by judicial courts[4], it is expected and welcomed that Portugal soon changes its legislation in order to establish an equal taxation regime to Portuguese resident and non-resident individuals in relation to capital gains obtained from the sale of immovable property.

Refrain from Submitting the Question for European Court of Justice Preliminary Ruling

Aside from the main tax question, the abovementioned Portuguese tax arbitration court decision also ruled that there was no need to submit the question to a preliminary ruling of the European Court of Justice, taking into consideration that

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the European law is clear and that from the existing European Court of Justice decisions already results the solution for the given question. Therefore, the Portuguese tax arbitration court refrain from submitting the question to the European Court of Justice and undertook the responsibility for the decision of the tax dispute.

In fact, this ruling was grounded on the European Court of Justice Decision from 6 October 1982 (Case no. 283/81 – "Cilfit"), which considered that whenever the correct application of the European Union law is so obvious as to leave no scope for any reasonable doubt as to the manner in which the question raised is to be resolved and whenever the national court is convinced that the matter is equally obvious to the courts of the other Member States and to the Court of Justice, such national court may refrain from submitting the question to the Court of Justice and take upon itself the responsibility for resolving it.

In our view, this decision from the Portuguese Tax Arbitration Court, although comprehensive and fully justified in light of the abovementioned European Union case law, is clearly far-reaching taking into consideration that Portuguese courts (and specifically arbitration courts), regardless of the clarity of the applicable law, usually tend to obtain preliminary ruling from the European Court of Justice whenever European Union principles are invoked (Article 267 of Treaty on the Functioning of the European Union) in order to enhance their decisions before the European Court of Justice.

As such, this decision is welcomed and definitely empowers the role of the Portuguese tax arbitration courts as alternative dispute resolution mechanisms within the Portuguese legal system.

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Referee List in Tax Matters

1 Formed under the Portuguese Administrative Arbitration Centre ("CAAD")
2 Which enhanced the Portuguese Tax Arbitration Court decision of 30 May 2018 (case no. 644/2017-T)
3 European Court of Justice decision of 18 March 2010 (case C-440/08 – "Gielen")
4 Decision of 30 April 2013 (case no. 1374/12) of the Portuguese Supreme Administrative Court

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