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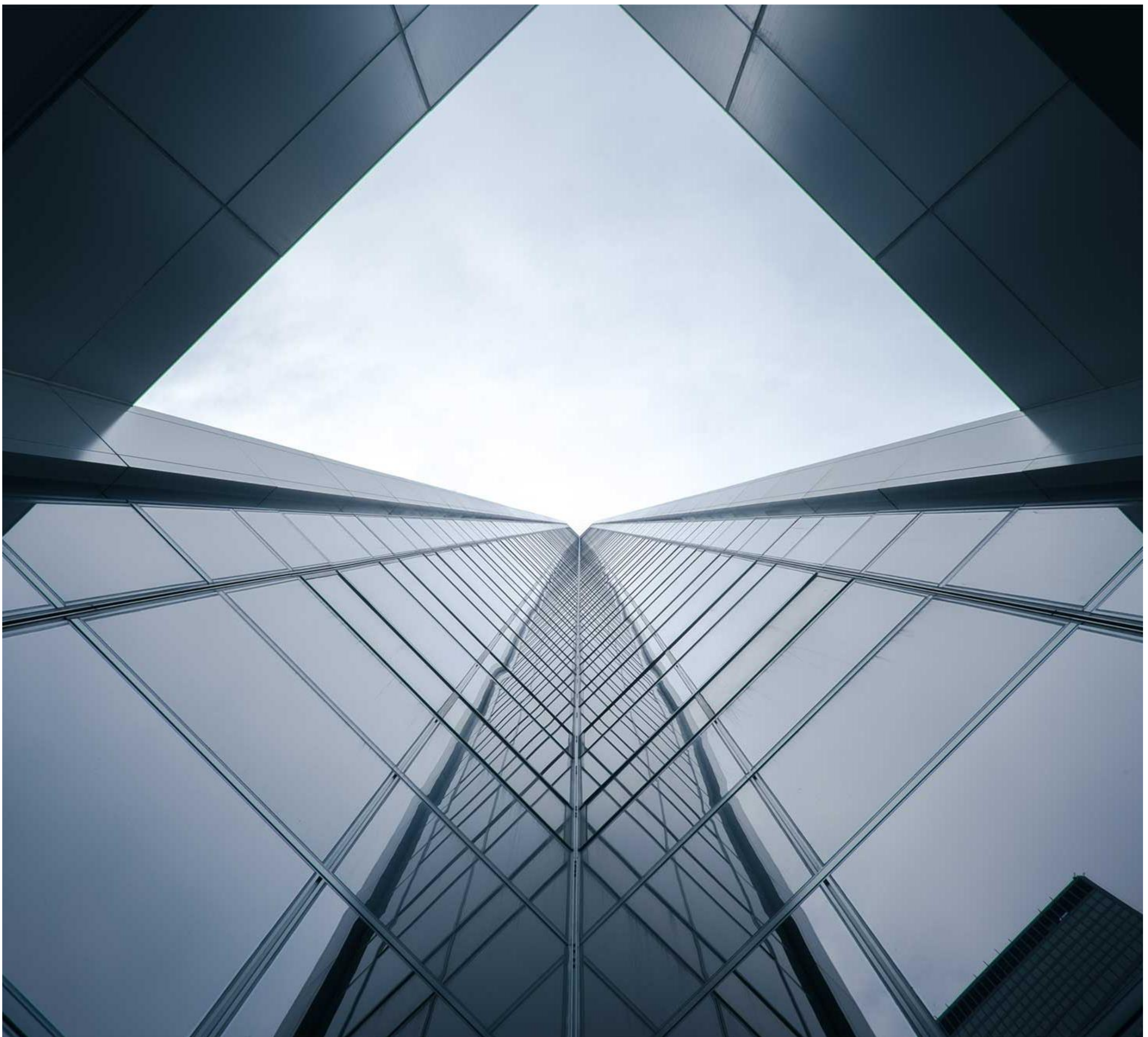
Tax



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Editorial

The second quarter of 2023 was again marked—as the beginning of the year had been—by the discussion of the "**More Housing**" program, ending with its final approval by Parliament. The tax measures approved include the following:

- End of golden visas for new residence visa applications for real estate investments
- Increased deduction on family Municipal Property Tax ("MPT"), depending on the number of dependents
- Reduction from 28% to 25% of the special Personal Income Tax ("PIT") rate on rents
- IRS exemption on capital gains from the sale of real estate to the State or the municipalities
- End of tax benefits for urban rehabilitation by investment funds
- Restricted scope of application of the lower VAT rate for urban rehabilitation works
- Approval of a short-term letting extraordinary contribution
- Approval of PIT and Corporate Income Tax ("CIT") incentives for owners who take their houses out of short-term letting
- Approval of tax benefits for construction of affordable rental housing, including reduction of the VAT rate to 6% and exemptions from MPT and Property Transfer Tax ("PTT")
- Approval of capital gains exemption on the sale of family-owned real estate

Companies should be aware of Ordinance 187/2023 of July 3, which approved the *Avançar* Program. This Program created an incentive for hiring qualified young people under permanent employment contracts, based on the combination of financial support for hiring and for paying social security contributions, which can be combined with other employment incentive measures.

As regards international tax, we are keeping an eye on the proposal for a Directive presented by the European Commission on June 19—**Faster Initiative**—aimed at making withholding tax procedures in the European Union more effective and secure for investors, financial intermediaries (such as banks) and tax administrations—a topic of extreme importance for European income tax standardization trends and one that will have developments in the coming months.

In case law, we have seen the dynamics of the Constitutional Court's ("CC") decisions on the ESEC as well as the Supreme Administrative Court Judgment of Nov. 24, 2021 in Case 23/21.6BALSB (2nd Section Plenary) which harmonizes case law on Stamp Duty, MPT and PTT exemptions regarding the original wording of article 8 of the legal regime on REIFHRs (Real Estate Investment Funds for Housing Rentals), upholding that these exemptions should be interpreted as being subject to the resolutive condition that the property must actually be allocated to permanent housing rental, being these tax benefits ineffective if the property is sold without having been rented or without the Minister of Finance authorizing its sale.

At a time of considerable legislative and court activity, the Cuatrecasas team is keeping up with current issues and trends in tax and parafiscal matters, being the following opinion articles included in this edition:

- António Schwalbach, André Areias and Francisco Ludovino Reis look at the indecision surrounding the ESEC.
- André Areias writes about licensing to stabilize the lower rate of VAT for urban rehabilitation.
- Tiago Martins de Oliveira and Catarina Leão analyze the changes to the new tax incentive on capitalizing companies.
- Daniel S. de Bobos-Radu and Beatriz Vale Rêgo comment on the VAT exemption for the administration or management of investment funds.

Serena Cabrita Neto
Portugal Tax Team Coordinator

The indecision surrounding the ESEC

As a result of the contradictory decisions recently issued by the Constitutional Court on the ESEC, we have conducted a critical analysis of the two different approaches to the issue.

By *António Schwalbach*, *André Areias* and *Francisco Ludovino Reis*

With the approval of the 2014 State Budget Law ("**SBL**"), an "extraordinary" contribution was created to fund mechanisms that would promote the systemic sustainability of the energy sector: the ESEC. Surprisingly— or perhaps not so surprisingly in view of the State's pressing need for tax revenue—this new contribution, created to apply only in 2014, is almost 10 years old.

Given the burden that the ESEC represents for operators in the national energy sector (amounting to around €125 million in 2022 according to the State's General Account), there has been much debate about the grounds for this contribution, and it has given rise to intense disputes in Portuguese courts.

Nonetheless, the indecision of the CC over the last six months with respect to this tax is surprising.

First, in Judgment 101/2023 of March 16, 2023, the CC judges at *Palácio Ratton* unanimously ruled that the ESEC was unconstitutional when applied to natural gas operators because it breached the principle of tax equality, but only from 2018 onwards. This is because the CC considered that most of the tax revenue would be allocated to reducing the electricity subsector tariff deficit after that date, in accordance with the legislation, and that operators that were not part of this subsector (such as natural gas subsector operators) should not have to contribute to the charges originating in it. This judgment was a clear shift in the Court's position—one that was highly praised by the taxpayers.

However, the CC took a different stance in Judgment 296/2023 of May 25, 2023, although with one dissenting vote. The CC concluded that reducing the electricity sector tariff deficit tended to benefit a homogeneous group of operators, including natural gas sector operators. According to this judgment, an unequal and unjustified (?) tax treatment for electricity and natural gas subsectors operators was likely to breach the principle of equality.

Finally, in June of this year, a possible approximation to the first judgment occurred. In Judgment 338/2023 of June 6, 2023, while not taking a firm position on the matter under discussion, the CC seemed to move in the direction of the first judgment, since it argued that, in 2018, there was a change in the ESEC layout and how ESEC revenue was allocated.

Although it is (almost) impossible to make predictions on which line of case law will be followed by the CC from now on, we can still assess some of the arguments discussed in these judgments.

First, the CC's March judgment sheds light on a core issue: a levy whose main purpose is financing the electricity subsector tariff deficit is being imposed on natural gas subsector operators at a time the ESEC is no longer being

presented as a contribution designed to finance the entire sector. In other words, there is no longer any obvious connection.

As with any levy —let us not forget that the ESEC is a financial contribution—lawmakers have a constitutional obligation to determine the tax base and grounds for the principle of equivalence with the required precision. However, the opposite is true in the case of the ESEC.

In addition, the following fact should also be considered in greater detail when analyzing the legality of the ESEC from 2018 onwards: according to data published by the Energy Services Regulatory Authority, the tariff deficit was €3,677 million in 2013 and climbed to a peak of €5,080 million in 2015. However, since then, the deficit has been decreasing and, today, it has reached a low €879 million.

Since the ESEC was created to reduce the tariff deficit (as confirmed by the 2019 SBL and the legislative authorization of the 2020 SBL) and the tariff deficit is at an all-time low, we might ask whether the very reason for the ESEC is still valid.

Given the obvious problems surrounding this levy, we hope that when the plenary session of the CC is called upon to establish case law and harmonize (contradictory) decisions, it will leave the past behind and follow the new, and correct, direction it took in March, which is that the ESEC no longer has a place in the country's tax system.

Stabilizing the lower VAT rate for urban rehabilitation works

Licensing to stabilize the lower VAT rate for urban rehabilitation works

With the spotlight on the More Housing package and urban development issues, the VAT on rehabilitation works also deserves special attention.

By *André Areias*

At the time of writing this article, the Portuguese Parliament has already cast its final vote approving the "More Housing Program." This program is the result of the Government's Bill 71/XV/1, and the legislative process should now proceed normally (barring any presidential brake or obstacle) to publication and entry into force.

One of the negative aspects of the approved measures is that the scope of application of the lower VAT rate is restricted to urban rehabilitation works carried out in urban rehabilitation areas.

Under the current wording of item 2.23 of List I attached to the VAT Code, urban rehabilitation works (as defined in a specific diploma) carried out on **buildings or public spaces** located in urban rehabilitation areas benefit from the lower VAT rate. However, under the new wording of item 2.23 in the More Housing Program, building rehabilitation, as well as construction or rehabilitation works on collective public use facilities in urban rehabilitation areas, can benefit from the lower VAT rate (in addition to the other situations provided by law).

Due to this abrupt change in the VAT framework for urban rehabilitation—with the lower rate no longer applying to works carried out on buildings or public spaces—that enables far more wide-ranging rehabilitation works than mere intervention on buildings, many developers and builders may see their projects affected.

In fact, urban rehabilitation projects that are underway when the new wording of item 2.23 enters into force may run the risk of falling under two different VAT regimes, with the same contract being subject to two different VAT rates (the lower rate and the regular rate), since the rules for charging tax on continuous services such as works contracts stipulate that VAT will be due at the end of the period to which each payment refers, and the rate in force on that date should apply.

However, applying two different VAT rates to the same transaction necessarily raises questions regarding legal certainty and neutrality that should not be underestimated. Therefore, we welcome the fact that lawmakers sought to safeguard real estate projects in progress from the new wording of item 2.23 by establishing a transitory rule that will be included in the final version of the law.

Under this rule, the new restrictive wording of item 2.23 will not apply to urban development operations that have submitted i) a license application, ii) a prior communication or iii) a prior information request to the relevant municipal council before the entry into force of the new law.

The new wording of item 2.23 will not apply either to urban development operations that have submitted license applications or prior communications to the relevant municipal council after the law enters into force if these were submitted in accordance with a valid favorable reply to a prior information request.

Therefore, and in anticipation of the entry into force of the law that will restrict the scope of application of the lower VAT rate to urban rehabilitation works, we must stress the importance of timing of the license application, prior communication or request for prior information by economic operators as a way of stabilizing the (lower!) VAT rate to be applied to urban rehabilitation works, thus ensuring the stability of the financial model they have developed for a particular real estate project.

Changes to the new tax regime on incentive for capitalizing companies

In times of high inflation and international crisis, it is a challenge for companies to strengthen their financial structures, and tax benefits play an even more important role.

By *Tiago Martins de Oliveira* and *Catarina Leão*

The 2023 SBL created the tax regime on incentive for capitalizing companies ("**ICC**") by introducing the new article 43-D of the Tax Benefits Statute ("**TBS**") and revoking the tax benefits that were associated with capitalizing companies, namely the Regime on the Conventional Remuneration of Share Capital ("**CRSC**") and the Regime on the Deduction of Retained and Reinvested Earnings ("**DRRE**").

This new tax benefit involves deducting to CIT taxable profit an amount calculated by applying the 4.5% rate to net increases in eligible equity. This amount can be increased by 0.5% if the taxpayer qualifies as a micro, small or medium-sized enterprise or a small mid cap company.

Regardless of the regulation regarding the eligible taxpayers and other conditions for applying this new tax benefit, the way of quantifying the benefit generated controversy, and it implied a change to the law—Law 20/2023 of May 17—less than five months after its entry into force.

What is the main problem caused by the initial wording of article 43-D of the TBS?

The initial wording of the regime meant that it would only apply to the arithmetical sum of the net increases in eligible equity in each of the nine previous tax years and that only tax years starting on or after January 1, 2023 should be considered.

Therefore, contrary to what seemed the lawmakers' intention, this regime would only apply from the 2024 tax year onwards, so there would be no company capitalization tax benefit for the 2023 tax year, since the CRSC and the DRRE regimes were revoked by the 2023 SBL.

What is the main change introduced by Law 20/2023?

Under the new wording of article 43-D of the TBS, "the amount of net increases in eligible equity will be determined by reference to the sum of the amounts calculated in that financial year and in each of the nine previous tax years."

In addition, the new transitory provision establishes that the first accounting profits covered by the CCI are those of 2022, whose resolution and corresponding application in retained earnings, reserves or capital increases occurred in the tax year beginning on or after January 1, 2023. This eliminates the main problem with the initial wording of the article.

Moreover, Law 20/2023 clarified that capital increases using profits generated in the 2022 tax year and that benefited under the previous CRSC regime will not be considered, as the lawmakers wished to avoid any duplication of tax benefits.

Therefore, the legislative vacuum regarding tax benefits associated with company capitalization that would affect the 2023 tax year has been eliminated by expressly establishing that the ICC applies to 2023.

Other changes introduced by Law 20/2023

In addition to solving the main problem caused by the initial wording of article 43-D of the TBS, the lawmakers also tried to clarify some concepts relating to the ICC.

The definition of eligible equity increases related to profits obtained in the previous tax year and used in retained earnings, reserves or capital increases was changed. Therefore, while the initial wording of the provision only mentioned accounting profits, the new wording of article 43-D of the TBS introduced by Law 20/2023 restricts the application of the ICC to distributable accounting profits under commercial legislation (see articles 32 and 33 of the Companies Code).

This change aims to exclude gains obtained by using the equity method from the scope of application of the ICC, thus avoiding this tax benefit being claimed by two different taxable persons for the same financial profit.

However, it remains to be seen whether it was expressly intended to exclude the application of the ICC to taxable persons that have negative retained earnings despite making an accounting profit since, under commercial law, the yearly profits required to cover retained losses cannot be distributed to shareholders.

In addition, and as regards the taxable persons eligible for the ICC, it was also clarified that it is not applicable to entities subject to the supervision of the Bank of Portugal, the Insurance and Pension Funds Supervisory Authority, the Portuguese branches of credit institutions, other financial institutions or insurance companies.

Although the main problem caused by the 2023 SBL was solved by Law 20/2023, some issues relating to the application of the ICC remain unresolved (such as whether the regime is compatible with the proposed directive to reduce the debt-equity bias—DEBRA Directive—especially as regards any additional restrictions on the deduction of financing costs). In addition, other issues have now been introduced (e.g., the restriction on distributable accounting profits under commercial law) that will probably only be clarified after the Tax Authority comes into contact with the practical application of the regime. Therefore, it is expectable that we revisit this issue in the near future.

VAT exemption on the administration or management of funds

The clarification by the courts of the applicability of the exemption on investment fund administration and management fees calls for an in-depth analysis of the scope of the exemption

By *Daniel S. de Bobos-Radu* and *Beatriz Vale Rêgo*

Following the recent judgments of the European Court of Justice ("E**CJ**") in *BlackRock* (C 231/19) and *K and DBKAG* (C 58/20 and C 59/20), it was the turn of the Arbitral Court set up in Case 484/2022-T to decide, on March 30, 2023, on the VAT exemption for investment fund administration or management.

The case involved a venture capital company ("**VCC**") that manages several investment funds. It is responsible for managing these collective investment undertakings and for generally carrying out all the acts and operations for these to be managed properly. To comply with its obligations, the SCR uses third-party services, including legal services, such as implementing the regulations on venture capital funds, preparing, creating and setting up funds, assisting to arrange unit holders meetings, and specific tax issues such as Stamp Duty on the services provided by the VCC.

The VCC and the law firm providing these services took the view that these services should benefit from the exemption laid down in article 9(27)(g) of the VAT Code (which transposed article 135(1)(g) of Council Directive 2006/112/EC of November 28, 2006), according to which the administration and management of investment funds is exempt from VAT.

According to ECJ case law, the exemption covers "the provision of services by third parties to management companies of investment funds, such as tax-related services consisting of ensuring that the income received from the fund by the unit holders is taxed under national law (...) provided that they have an intrinsic link with the management of common funds and are provided exclusively to manage those funds, irrespective of whether they are fully outsourced" (see *K and DBKAG* (C 58/20 and C 59/20), paragraph 68).

As the ECJ stated in *ATP PensionService* (C 464/12), among others, the basis for this exemption is that it favors the access of small investors to the securities market, since common management of investments in investment funds offers them the possibility of holding a diversified portfolio that protects them against the risks involved in the fluctuating value of securities and spreads the cost of specialized management. Otherwise, the tax neutrality principle would prevent economic operators that conduct the same transactions from being given a different VAT treatment.

In the case at hand, the arbitral tribunal held that, as there were no corrections to the invoices, and the impossibility of using the invoices to exercise the right to deduction was not proven, it was not a situation in which self-assessments annulment could be allowed. This is also clear from the express content of article 97(3) of the VAT Code that establishes that "assessments may only be cancelled when it is proven that the tax was not included in the invoice issued to the purchaser under article 37."

The respondent tax authorities add that "if the applicant's understanding is that it should not have assessed VAT on the invoices, i.e., that it has unduly assessed VAT on the invoices, then it should correct the invoices (whenever it is still in time to do so) and, under article 78 of the VAT Code, regularize the tax in its favor, after following the procedure laid down in that article."

Although this arbitral decision was limited by formal and procedural aspects, the ECJ case law at stake, following on from earlier cases such as *Abbey National* (C-169/04) and *GfBk* (C 275/11), confirms the application of the exemption to certain services provided in specific circumstances in the context of investment fund management.

It is likely that there will be more internal disputes. Therefore, management companies should review the services outsourced to third parties to assess whether they are likely to benefit from this VAT exemption, and company management service providers should also assess the impact of this case law on their active perations.

In our view, while the ECJ's case law created the illusion of a relatively broad scope of application of the exemption, the specific requirements proposed by the ECJ should not be underestimated: services (i) must have an intrinsic link with the management of common investment funds, and they (ii) must be provided exclusively to manage these funds.

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