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Euro Tax Flash from KPMG's EU Tax Centre

Background

The CJEU decision

EU Tax Centre comment

CJEU decision on mitigation of a discriminatory regime – Portuguese taxation of capital gains – Election for resident taxation cannot eliminate discrimination

CJEU – Portugal – Capital gains on immovable property – Taxation of non-residents – Discrimination

On March 18, 2021, the Court of Justice of the European Union ('CJEU' or 'Court')) rendered its decision in *MK v Autoridade Tributária e Aduaneira* case (C-388/19) concerning the compatibility with EU law of the Portuguese tax on capital gains on immovable property realized by a non-resident taxpayer.

The Court essentially held that simply giving non-residents the choice to be treated as residents for the purposes of the Portuguese regime on capital gains from the sale of immovable property situated in Portugal is not sufficient to make the regime compatible with EU law, if that regime otherwise continues to have discriminatory effects.

Background

In 2017 a French resident individual realized a capital gain on the sale of Portuguese real estate. Under Portuguese tax law, only 50 percent of capital gains on real estate made by persons resident in Portugal is taken into account in determining the taxable amount and a tax rate per bracket is applied on this amount. The highest bracket, applicable to the proportion of income in excess of EUR 80,640, was taxed at 48 percent. Instead, the same capital gains, if realized by non-resident taxpayer, are taxed at a flat tax rate of 28 percent, without benefitting from the 50 percent tax base reduction in the value of the capital gain to be taken into account.

Following the decision on *Hollman v. Fazenda Publica case* (C-443/06) – where the CJEU found that the Portuguese tax on capital gains on immovable property realized by a non-resident taxpayer was not compatible with EU law – the Portuguese tax regime was amended in two ways.

- The Portuguese Government gave the persons who are resident in another EU Member State the choice between opting to be taxed either as a resident or as a non-resident.
- An additional solidarity tax (the rate of which was 5 percent on the bracket of income in excess of EUR 250,000), applicable only to persons resident in Portugal, was introduced.

In 2018 the Portuguese tax authority issued to the French taxpayer a notice of assessment, applying the tax regime for non-residents and, thus, denying the 50 percent reduction of the taxable base granted to resident taxpayers, since the taxpayer did not opt for being taxed in the same way as a resident person. The French individual challenged this position and argued that the Portuguese tax rules applicable to non-residents breach the free movement of capital under Article 63 of the Treaty on the Functioning of the EU ('TFEU').

On May 17, 2019 the Portuguese Tax Court decided to refer to the CJEU the question of whether the Portuguese capital gain tax treatment, to the extent that it allows a non-resident to make the election to be treated as a resident of Portugal, is in line with the free movement of capital.

On November 19, 2020, Advocate General ('AG') Hogan concluded that the Portuguese legislation on taxation of capital gains realized by non-residents should not constitute a restriction on the free movement of capital in so far as the non-residents are entitled to opt for the tax regime applicable to residents, and provided that the possibility of making such a choice has been brought to the attention of the non-residents in a clear, timely and intelligible manner and the consequences attached to the fact that the whole of the income of the person concerned is not taxed in that State are neutralized.

The CJEU decision

The CJEU gave its decision in light of the free movement of capital and examined whether there is a difference in treatment between taxation of Portuguese resident individuals and non-resident taxpayers with respect to the taxation of capital gains realized from the sale of an immovable property situated in Portugal.

In this regard, the Court observed that under the Portuguese tax rules, despite the additional solidarity surcharge, persons resident in Portugal are systematically taxed at a lower effective tax rate than non-residents. Contrary to the AG's opinion, the Court held that the difference in treatment continues to represent a restriction on the free movement of capital prohibited by Article 63(1) TFEU.

Neither – the Court stated – can such a restriction be justified on any of the grounds provided for in paragraphs 1 and 3 of Article 65 TFEU since, on the one hand, the difference in treatment between resident taxable persons and non-residents taxable persons provided for by Portuguese legislation concerns situations that are objectively comparable and, on the other hand, this difference in treatment is not justified by overriding reasons in the public interest.

In particular, as regards the comparability of the situations, in line with its previous judgement the tax regime in question (see the Hollman case mentioned above), the CJEU affirmed that the French taxpayer's situation is comparable to that of a resident since:

i) the tax on capital gains from the sale of immovable property relates to a single category of income of the taxpayers, whether they are residents or non-residents,
ii) that tax relates to those two categories of taxpayers,
iii) the Member State in which the taxable income is generated is, in both cases, Portugal, and
iv) a Portuguese tax resident, for whom the basis of the capital gain was reduced by 50%, pays systematically less tax than a non-resident.

As far as the justification based on overriding reasons in the public interest is concerned, the Portuguese government, though it did not mention the existence of such reasons, argued that, in the context of the taxation of the positive balance of capital gains on immovable property earned in Portugal, the purpose of the Portuguese tax regime is to prevent taxpayers resident in Portugal or non-resident taxpayers, who choose to be taxed as such, from being disadvantaged by having a progressive rate applied to them. The CJEU held that the compensation for the disadvantage that resident taxpayer may have (i.e. progressive tax rates) cannot be accepted, as the compensation was (due to the 50% reduction in tax base) always higher than the disadvantage, and consequently the restriction resulting from the tax legislation in dispute cannot be justified by the need to ensure the cohesion of the tax system.

Finally, with respect to the option for non-residents to be taxed under the same rules applicable to residents, the CJEU noted that the presence of such an election cannot eliminate the discriminatory effect of the regime for non-residents. Indeed, in the Court's opinion, if it were to be recognized that the election has such an eliminating effect, the consequence would be to regard as lawful a tax regime which, in itself, because of its discriminatory character, would still be in breach of Article 63 TFEU.

EU Tax Centre comment

In this decision the CJEU affirmed the fact that a tax legislation, even though it allows non-residents taxpayers to be taxed in the same way as resident taxpayers, cannot make the restriction – that resident taxation is systematically more advantageous than non-resident taxation – compatible with the TFEU and, consequently, is contrary to the free movement of capital.

The CJEU's decision in the MK case is for example relevant in the context of the Dutch Supreme Court decision of 23 October 2020 on Dutch withholding tax on dividends paid to foreign investment funds (Köln Aktienfonds Deka, see Euro Tax Flash Issue 433 for further detail). In its October 2020 decision, the Dutch Court proposes as a solution for the disadvantageous treatment of non-Dutch funds the introduction of an election for foreign funds to make a replacing payment in order to apply for a refund of the Dutch dividend withholding tax paid. In light of the CJEU's decision in the MK case, it can be argued that giving foreign funds this option does not correct the restriction on the free movement of capital in so far as it does not bring non-resident funds to par with Dutch based investment funds, which are able to pass on the underlying dividend withholding tax to the shareholders in the fund, whereas non-resident funds are not.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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