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Comment on the European Court of Justice case C-388/19, 18.03.2021

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Abstract

Article 63 TFEU, read in conjunction with Article 65 TFEU, must be interpreted as precluding the legislation of a Member State which, in order to permit the capital gains realised from the transfer of immovable property situated in that Member State, by a taxable person resident in another Member State, to not be subject to a tax burden greater than that which would be applied to capital gains realised from the same type of transaction by a person resident in the first Member State, makes the taxation regime applicable dependent upon the choice made by that taxable person

Keywords: Art.65 TFUE; material principles; admissibility of discriminatory regimes; coherence of the tax regime; contrast with international law.

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1. Premises

In order to fully understand the case we are going to analise we should bear in mind the following relevant data:

1. Until 1989 realised capital gains made on transfer of immovable propriety by individuals where not subjected to tax.
2. On the 1989 enactment of the IRS (Revenue Tax on Individuals) a transitional rule[1] was enacted in order to ensure that capital gains obtained on transfer of previously owned propriety is not subjected to tax.
3. Capital gains obtained by individuals on the transfer of the family residence (main abode) fully reinvested in the acquisition of a new residence are not subject to tax.
4. Tax on capital gains resulting from the transfer of immovable propriety made by residents is only 50% of the effective gain according to the article 43. n.º 2 b) of the IRS.
5. According to article 72.º of IRS the non-residents pay 28% of the full capital gain obtained from transfer of immovable propriety.

The facts:

A. A European resident bought a house in Portugal.

B. Sometime after he sold the house with a capital gain.

C. The taxpayer declared the operation to the Tax Authorities and was taxed accordingly to the law with 28% special rate on the full gain.

D. The taxpayer paid the tax and subsequently applied for Arbitral Tax Court (CAAD) in order to obtain the annulment of the tax liquidation.

E. The case was submitted to the European Court of Justice (1st Chamber) under the number C-388/19.

2. The Opinion of the Advocate General[2]

The Advocate General starts by reaffirming the basic principles and proceeds to referring the «state of the art» of similar cases.

«At the outset, it may be recalled that direct taxation remains essentially within the competence of the Member States. It is up to them to determine the scope of their tax jurisdiction as well as the basic principles of their tax system. In the current state of harmonisation of national tax legislation, they are accordingly free to establish the system of taxation that they consider appropriate including, in particular, to provide for a system of progressive taxation or for a flat tax. In this context, Member States may impose such reporting and administrative obligations as they deem necessary to ensure effective tax collection.

Fundamental freedoms relating to the internal market cannot, therefore, be understood as meaning that a Member State is required to align its tax rules with those of other Member States in order to ensure that any disparities arising from the application of these national tax rules are thereby eliminated. Accordingly, two Member States may even tax the same transaction on the basis of a different connecting factor. All of this means that freedoms of movement – important though they are – are not intended to solve any problems of interoperability between the different national taxation systems. They only aim at ensuring that Member States exercise their competences in a

1. Article 5 of the Approval Law of IRS: DL n.º 442-A/88, de 30 de November.

2. We use transcriptions of the relevant documents: Advise of the Attorney General and Court Decision.

non-discriminatory manner. In particular, it is not for the Court to say what the tax system of the Member States should be like.

Member States must nevertheless exercise their fiscal competence in a manner which is consistent with the principle of freedom of movement. This means that Member States must refrain from adopting discriminatory measures to the detriment of persons who have exercised their right to freedom of movement.

In areas other than taxation, any national measure that prohibits, hinders or renders less attractive the exercise by EU nationals of a freedom of movement guaranteed by the Treaty constitutes a restriction on that right of free movement, even if that measure is indistinctly applicable prima facie.

In tax matters, however, the concept of 'restriction' is applied in a somewhat more limited fashion. Indeed, the mere fact of imposing a tax on an activity or transaction necessarily makes engaging in that transaction less attractive. In order, therefore, not to prejudice the ability of Member States to levy taxes, the Court's case-law to date suggests that the national measure at issue must also give rise to either a direct or indirect discrimination in order for that measure to be regarded as a 'restriction' in this sense. In turn, the test to be applied in order to establish the existence of a restriction in tax matters is therefore identical to the one to be applied in matters other than taxation.

The necessity for a non-discrimination test – and, therefore, for examining the comparability of the two situations in order to classify a measure as a 'restriction' in this sense – must be considered as having been definitely established since the judgment of 17 July 2014, Nordea Bank Danmark (C-48/13, EU:C:2014:2087). In that case, Advocate General Kokott proposed abandoning the non-discrimination test and instead urged the application to tax matters of the same test as those applied in other areas. The Court, however, did not follow her Opinion in that respect. In addition, where, as in the present case, the free movement of capital is at issue, the need for such a comparison flows from the wording of Article 65 TFEU.

Taking the decision in Nordea Bank as my starting point, one must, I think, inquire whether there is a discrimination amounting to a restriction on the free movement of capital in the case of Article 63 TFEU.

Before going any further, I should pause to observe that there are essentially two problems particular to the question of discriminatory taxation and, therefore, of restrictions on free movement in the field of taxation. The first concerns the way in which the concept of 'discrimination' should be understood in that context.

A first approach suggests that any measure having, in the case of direct discrimination, as its object, or, in the case of indirect discrimination, as its effect, to treat comparable situations differently or, conversely, to treat different situations identically, constitutes discrimination.

According to the second approach, where the law prohibits the use of a specific criterion, a direct discrimination occurs when a person is treated less favourably by reference to the express terms of such a criterion. By contrast, an indirect discrimination exists when a provision or criterion which appears neutral is nonetheless applied in a manner which places some persons at a disadvantage compared with others by reference to some prohibited criterion.

At the risk of stating the obvious, the real form of discrimination is the final amount of tax that non-residents will have to pay for the realised real estate capital gain if that is greater than the amount which would have been charged to residents in respect of the same transaction. Consequently, what was relevant was not so much the non-application of the 50% reduction in the taxable base, but rather the overall effective tax rate which was in fact applied, resulting from the combined effect of the percentage of taxable base taken into account and the applicable tax rate.

Even in the absence of the 50% reduction on the taxable base, the legislation described by the referring court in Hollmann would have in any case been regarded as establishing a difference in treatment, since it subjected capital gains realised by a non-resident with a low income to a flat tax rate of 28%, whereas the same capital gains made by a resident with the same low income might be taxed according to a bracket scale whose lowest tax rate was lower than 28%.

In fact, due to the use by Portugal of a progressive rate imposed on all income (including realised capital gains), (which is the regime which generally applies to residents) on the one hand and a fixed rate of capital gains on the other (which is the regime which is generally applicable to non-residents with no other income taxable in Portugal in respect of once-off capital gains), it is almost inevitable that, in certain comparable situations, some non-resident taxpayers will be treated less favorably than resident taxpayers. Indeed, according to the Court's case-law, any unjustified restriction, even of minor importance, on the free movement of capital is to be regarded as discriminatory. It is thus generally sufficient for a tax law to introduce direct or indirect discrimination in respect of even one taxable person in a cross-border situation, for that legislation might be considered incompatible with EU law.

3. Free movement of capital[3]

Should be recalled that Article 63 TFEU prohibits all restrictions on the movement of capital between the Member States, subject to the justifications laid down in Article 65 TFEU.

In the present case, it is clear from the order for reference that Article 43(2) and Article 72(1) of the CIRS laid down, in the case of capital gains realised from the transfer for valuable consideration of immovable property situated in Portugal, taxation rules which vary depending on whether or not the taxable persons liable to income tax were resident in the territory of that Member State.

In particular, under Article 43(2) of the CIRS the amount of capital gains realised by residents when transferring immovable property situated in Portugal were to be taken into account as to only 50% of their amount. By contrast, for non-residents, Article 72(1) of the CIRS provided that the full amount of those same capital gains was to be taxed at the autonomous rate of 28%.

It follows that, by the application of those provisions, the basis for the assessment of tax on such capital gains was not the same for residents and non-residents. Thus, for the sale of the same immovable property situated in Portugal, if capital gains are realised, non-residents are subject to a tax burden greater than that applied to residents and are consequently in a less favourable position than the latter (see, to that effect, judgment of 11 October 2007, Hollmann, C-443/06, EU:C:2007:600, paragraph 37).

Although under Article 72(1) of the CIRS, a non-resident was taxed at a rate of 28% applied to a basis for assessment representing the total amount of the capital gains realised, the taking into account, as the basis for assessment, of only half of the capital gains realised by a resident enables the latter to benefit systematically from a tax burden which, for that reason, is lower regardless of the tax rate applicable to the whole of his income, since, according to the observations made by the Portuguese Government, residents' income was subject to tax in accordance with a scale of progressive rates, under which the highest rate was 48%, and that is so even though an additional solidarity levy of 2.5% could be applied to taxable income between EUR 80000 and EUR 250000 and of 5% above that amount.

The Court has already had occasion to hold, in the judgment of 11 October 2007, Hollmann (C-443/06, EU:C:2007:600, paragraph 40), that the fixing by Article 43(2) of the CIRS of a basis of assessment of 50% that applies only to capital gains realised by taxable persons residing in Portugal and not to those realised by non-resident taxable persons constituted a restriction on the movement of capital prohibited by Article 63 TFEU.

3. Position of the Court.

That finding is not called into question by paragraph 44 of the judgment of 19 November 2015, Hirvonen (C-632/13, EU:C:2015:765), in which the Court held that a difference in treatment between non-resident and resident taxable persons, consisting in the fact that it subjects the income of non-residents to a definitive tax at the single rate of 25%, deducted at source, whilst the income of residents is taxed according to a progressive scale, including a tax-free allowance, is compatible with EU law provided that the single rate is not higher than that which would actually be applied to the person concerned, in accordance with the progressive scale, in respect of net income increased by an amount corresponding to the tax-free allowance. In the present case, as is clear from paragraph 29 of the present judgment, the tiered taxation system in dispute means that non-residents are systemically subject to a tax burden greater than that applied to residents where capital gains are realised on the sale of property.

In those circumstances, fixing the basis for assessment at 50% for capital gains realised by all taxable persons residing in Portugal but not for non-resident taxable persons who have opted for the tax regime provided for in Article 72(1) of the CIRS constitutes a restriction on the movements of capital prohibited by Article 63(1) TFEU.

It must therefore be examined whether such a restriction can be held to be objectively justified under Article 65(1) and (3) TFEU.

4. Whether the restriction on the free movement of capital under Article 65(1) and (3) TFEU is justified

It follows from Article 65(1) TFEU, read in conjunction with Article 65(3), that the Member States may distinguish in their national legislation between resident and non-resident taxable persons provided that such a distinction does not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital.

It is therefore necessary to distinguish between unequal treatment that is permitted under Article 65(1)(a) TFEU and arbitrary discrimination that is prohibited under Article 65(3) TFEU. In that respect, it follows from the case-law of the Court that, in order for national tax provisions, such as Articles 43(2) and 72(1) of the CIRS, to be regarded as compatible with the Treaty provisions on the free movement of capital, the difference in treatment must either relate to situations which are not objectively comparable or be justified by an overriding reason relating to the public interest (see, to that effect, judgment of 11 October 2007, Hollmann, C-443/06, EU:C:2007:600, paragraphs 44 and 45 and the case-law cited).

In the present case, the difference in treatment between resident taxable persons and non-resident taxable persons laid down in the Portuguese legislation concerns situations that are objectively comparable. Furthermore, that difference in treatment is not justified by an overriding reason in the public interest.

As regards, in the first place, the comparability of the situations, it should be noted that the Court has already ruled in paragraph 50 of the judgment of 11 October 2007, Hollmann (C-443/06, EU:C:2007:600), first, that the taxation of the capital gains resulting from the transfer of immovable property concerns, under Article 43(2) and 72(1) of the CIRS, only one category of taxpayers' income, irrespective of whether they are residents or non-residents; secondly, that taxation concerns both categories of taxpayer and, thirdly, the Member State in which the source of that taxable income is located is the Portuguese Republic in both cases.

It follows from the above and in particular from paragraph 29 of the present judgment that there is no objective difference between resident taxpayers and non-resident taxpayers that is capable of justifying an inequality of tax treatment between them, under Articles 43(2) and 72(1) of the CIRS, as regards the taxation of the positive balance of capital gains realised following the transfer

of immovable property situated in Portugal. Consequently, the situation in which a non-resident taxpayer, such as MK, finds himself is comparable to that of a resident taxpayer.

That finding is not called into question by the ratio legis of Article 43(2) of the CIRS laying down the 50% allowance applicable to capital gains made by residents, which, according to the Portuguese Government, is to avoid the excessive taxation of such income which is considered abnormal and fortuitous since it cannot be ruled out that that consideration could apply to non-resident taxable persons.

As regards, in the second place, whether there are justifications based on overriding reasons in the public interest, it should be noted that the Portuguese Government does not assert that there are such reasons. Nevertheless, it argues that, in the context of the taxation of the positive balance of capital gains on immovable property realised in Portugal, Article 43(2) of the CIRS seeks to avoid penalising taxable persons residing in Portugal or non-resident taxable persons choosing to be taxed as such under Article 72(9) and (10) of the CIRS due to the application of a progressive rate to them.

In paragraphs 58 to 60 of the judgment of 11 October 2007, Hollmann (C-443/06, EU:C:2007:600), the Court held that the tax advantage granted to residents, consisting of a reduction by half of the basis for the assessment for tax on capital gains realised, outweighs, in any event, the consideration for that advantage, namely the application of a progressive rate to the taxation of their income. Consequently, the Court took the view that, in the case giving rise to that judgment, a direct link between the tax advantage and the offsetting of that advantage by a particular tax levy was not established and that that the restriction resulting from the national legislation in dispute could not be justified by the need to ensure the cohesion of the tax system.

5. Option to be taxed under the same arrangements as for residents

It should be noted from the outset that the possibility for persons resident in the European Union or in the EEA to opt, under Article 72(9) and (10) of the CIRS, for a taxation regime analogous to that which applies to Portuguese residents, and to thereby benefit from the 50% allowance provided for in Article 43(2) of that code, affords a non-resident taxpayer, such as MK, a choice between a discriminatory tax regime, namely that provided for by Article 72(1) of the CIRS, and another which would not be discriminatory.

In that respect, it is important to stress that, in the present case, such a choice is not capable of excluding the discriminatory effects of the first of those two taxation regimes.

If it were recognised that such a choice had that effect, the consequence would be to validate a tax regime which, in itself, remains contrary to Article 63 TFEU by reason of its discriminatory nature (see, to that effect, judgment of 18 March 2010, Gielen, C-440/08, EU:C:2010:148, paragraph 52).

In addition, as the Court has already had the opportunity to state, a national scheme which restricts a fundamental freedom guaranteed by the TFEU, in the present case the free movement of capital, remains incompatible with EU law, even if its application is optional (see, to that effect, the judgment of 18 March 2010, Gielen, C-440/08, EU:C:2010:148, paragraph 53 and the case-law cited).

It follows that the choice, in the case in the main proceedings, open to the non-resident taxpayer to be taxed under the same arrangements as resident taxpayers is not such as to render the restriction found in paragraph 32 of the present judgment compatible with the Treaty.

In the light of all the foregoing considerations, the answer to the question referred is that Article 63 TFEU, read in conjunction with Article 65 TFEU, must be interpreted as precluding the legislation of a Member State which, in order to permit the capital gains realised from the transfer of

immovable property situated in that Member State, by a taxable person resident in another Member State, to not be subject to a tax burden greater than that which would be applied to capital gains realised from the same type of transaction by a person resident in the first Member State, makes the taxation regime applicable dependent upon the choice made by that taxable person».

6. Comments

Article 65 TFEU accepts national solutions that may have discriminatory rules that are needed to preserve the coherence of the State tax system.

Jurisprudence from ECJ has become more and more restrictive on the application of this possibility.

In this Case the fact that the (non-resident) taxpayer could choose from two choices: i) one exclusively for non-residents (to be taxed at 28% for all capital gain; ii) adopt the resident regime and be taxed only on the 50% of the capital gain but with the rate that would be determined by his world-wide income.

This creates serious problems for the international law principles that are based in this fundamental distinction keeping the right to tax world-wide income for the resident State and the obtained income for the source State.

This distinction is of course to be tuned with the fundamental liberties of the Treaty and the aim of achieving a Single Market.

In a Single Market the freedoms cannot be armed by any solution that – either in fact or potentially – would harm the free movement of capital.

The Portuguese tax law solution does harm the freedom of movement of capital because it creates unjustified discrimination for the non-resident taxpayer.

In addition, the Portuguese Tax authorities, when trying to create a equality by applying to the non-resident, the resident rules creates a breach in the balance obtained in international tax law (fundamental distinction between resident and non-resident rules) without solving the problem of discrimination.

The European process will surely determine changes in tax rules and practices in order to obtain an Internal Single Market. These changes are supposed to help achieve this goal in the respect for fundamental freedoms that accept exceptions as long as they do not jeopardise in itself and in the goals they promote.

The above transcript Court Decision is not aligned with the one of the Advocate General because this ruling defines that a national law is against the principles even when does not create a discrimination in it´s application. A potentially harmful national law even if not applied is contrary to the fundamental freedoms as they are defined in articles 63 And 64 of the TFUE.

This means that these principles are material and enforcement principles and just not mere complementary rules needed for the good functioning of the internal market.

The genesis and consequences for the concept and application of the European Fiscal Law in direct taxation is clearly showed in this Court Decision.

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