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Human vs Machine - Taxation of Capital Gains on Financial Investments

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By Kore Partners

When it comes to tax matters, the devil is in the tax details. When reporting capital gains for personal income tax purposes the devil is mostly in the "machine", as the tax return processing algorithm could misinterpret the law, and naturally in tax authorities' favour.

Capital gains on realisation of financial investments are taxed on the amount of the difference in acquisition value and disposal proceeds, with certain adjustments for expenses or inflation. As from 1 January 2023, a distinction based on the holding period determines that short-term gains (less than 1 year) from shares and other securities will be taxable above certain thresholds at the highest progressive rates, whilst long-term gains and other gains on financial investments will be taxable at flat rate of 28%.

Practice has demonstrated the electronic reporting system is full of pitfalls that either require pre-planning or post-tax assessment litigation. This briefing deals with three recent Arbitration Court decisions which perfectly exemplifies the battle of human against the machine when reporting capital gains in Portugal.

Practice has demonstrated the electronic reporting system is full of pitfalls

Case 1: 175/2022-T decided on 14 November 2022

The first Arbitration Court decision deals with the case which expenses could be considered in determining capital gains under personal income tax, namely if the so-called "management fees" connected with discretionary portfolio management paid to a bank should be considered "*necessary and effectively incurred expenses, inherent to the acquisition and disposal*" of securities.

The Portuguese tax authority's position was that such expenses do not fall within the concept of "inherent/indispensable" and should be disregarded. This is reflected in the tax return design. In this case, they argued that contracting a portfolio management contract with a financial institution does not constitute a prior condition for a taxpayer realizing any capital gain transaction. In their view, it is not possible to establish a relationship between the expenses and the financial operations declared in the tax return. As such, the amounts paid are a remuneration arising from technical knowledge provided within the scope of financial advice without any direct correlation to each of the transactions giving rise to capital gains.

Management fees paid in the framework of discretionary portfolio mandates were considered necessary expenses

For the taxpayer, portfolio management always requires study and specialized knowledge, which is not at disposal of a normal taxpayer who is not a financial industry professional. The fact that fees are charged periodically at previously agreed amounts does not change the fact that they are a consideration due for the active management (i.e. for the acquisition/disposal) of the transferred securities. Disregarding those expenses would ultimately be unconstitutional as a breach of principles of ability to pay and equality.

The Arbitration Court agreed with the taxpayer. Management fees paid in the framework of discretionary portfolio mandates were considered necessary expenses (in the sense of being indispensable) and inherent (in the sense of being inseparable) to the acquisition and disposal of securities carried out within the scope of such agreement. In reaching this decision, the Arbitration Court highlighted that:

- Seeking profitability is not just an act of preservation and investors contracting a portfolio discretionary management aim that such management becomes ultimately profitable. This is relevant because in certain situations (for example due to the value of assets or other circumstances) it is not advisable to invest in financial markets without the intervention of a financial intermediary.
- The taxpayer's option, materialized in the conclusion of a portfolio management agreement against a quarterly management fee aims at managing and yield increase of a diversified portfolio of financial assets. The fact that the agreement refers to "study" should not be interpreted as separate or autonomous financial advice, as the acquisition and disposal of securities is the final step in the portfolio management process.
- A direct link between each securities acquisition/disposal (as the tax return indicates) is not necessary in order to allow the allocation of amounts paid as management fees to a specific operation.

This Arbitration Court decision is a good precedent on what we hope may be a reversal of a restrictive interpretation of the tax authorities on the issue of the expenses related to financial investments.

Case 2: 268/2022-T decided on 29 December 2022

Portuguese income tax includes a specific anti-abuse rule that disregards any capital losses if the counterparty of a transaction is a resident in a blacklisted jurisdiction.

In this second case, the Arbitration Court was asked to address the actual application of this rule when capital losses on the disposal of shares traded in the public markets were disregarded for the mere fact that the security issuers were residents of a blacklisted jurisdiction (e.g., Cayman Islands).

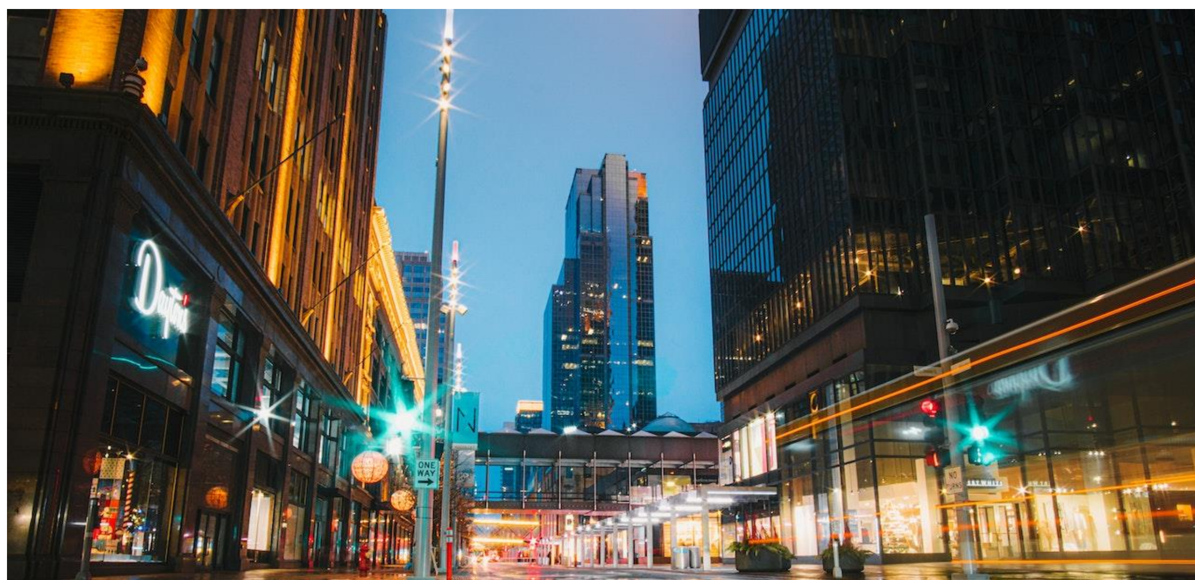
For the taxpayer, this specific anti-abuse rule simply did not apply to the sale of securities issued by entities in blacklisted jurisdictions. The taxpayer argued that the term "counterparty" was the condition to disregard losses; and that the actual "counterparty" in public financial markets is the company managing the trading system. Assimilation of the counterparty to the issuer was a "fiction" attributable exclusively to the way the electronic tax return was designed. In addition, the taxpayer defended that considering the mere fact of the issuer of quoted shares being resident in a blacklisted jurisdiction as tax avoidance or evasion was simply unreasonable.

a maze of rules dealing with investments in blacklisted jurisdictions often results in overshot

In turn, the Portuguese tax authorities argued that the specific anti-abuse rule aims to deter financial investors from making their investments in blacklisted jurisdictions and thus obtain lower taxation. For them, the expression "counterparty of the transaction" refers to the issuer of the securities, source country or domicile of the issuer.

Here, the Arbitration Court equally favoured the taxpayer. First, it started by carrying out an exercise in the light of legal interpretation rules of "who is the counterparty" of disposal transactions carried out in the open market. In the view of the Arbitration Court, the counterparty corresponds to the other party, the opposing party in a legal relationship. From a literal point of view, the opposing party of the transferor is the acquirer. Differently from another specific anti-abuse rule where the legislator expressly used the term "issuer", in this specific case, and because the rules determine the tax base, there was no space for extensive or corrective interpretation to go beyond the acquiring entities being "counterparties".

This Arbitration Court decision is another good precedent in an area where a maze of rules dealing with investments in blacklisted jurisdictions often results in overshot.



Case 3: 412/2022-T decided on 30 November 2022

NHRs in Portugal benefit for 10 years from the ability to exempt certain items of foreign passive income provided they may be taxable in the source jurisdiction. When it comes to capital gains on financial investments, Brazil is one of the few countries that has secured source taxing rights in the tax treaty with Portugal on all types of capital gains sourced in Brazil. In practice, this means that an NHR deriving capital gain from financial investments sourced in Brazil will benefit from the exemption method (while for most other jurisdictions, 28% will apply).

The third and final Arbitration Court decision deals with the case of an NHR deriving capital losses from financial assets in Brazil and whether or not these may offset capital gains derived from other sources.

The exemption method is part of the elimination of international double taxation for NHR

For the tax authority's viewpoint, the exemption method is part of the elimination of international double taxation for NHR and substitutes the tax credit regime. This means that if such capital losses were to be taken into account, in addition to the waiver of the ability to tax, Portugal would also be deprived of taxing gains via the offset that do not benefit from the exemption regime (from third countries). From the moment gains are exempt for an NHR, they should no longer be considered for determining the calculation of any balance of gains/losses to be taxed or take any loss to be deducted or reported.

From the taxpayer's perspective, that approach was not in line with the schedular system of the Portuguese income tax as it constituted an attempt to "anticipate" the application of exemption method to the rules of tax base determination. The rules of capital gains sets clearly for the balance of gains and losses of all operations and exclusion of transactions within the exemption method is not provided by law.

The only actual restriction refers to losses in transactions where the counterparty is in a blacklisted jurisdiction (which was not the case at hand). Moreover, if the Brazil-source losses were to be considered in the overall balance of capital gains and losses, the end result in this case would be negative.

Again, the Arbitration Court favored the taxpayer. An interpretation that has the effect of segregating gains and losses based on the mere susceptibility of whether they are taxable in the source country was held invalid as the two balances would not communicate with each other under the category of income. In addition, it also violated the constitutional principle of ability to pay. The taxable income is and should remain being the result of all capital gains and losses for the year. The tax base determination should be defined in accordance with Portuguese domestic law as tax treaties do not create taxation.

This final Arbitration Court decision is another good precedent even if we are aware of an opposing later decision on identical facts (345/2022-T). We agree with the Arbitration Court that the interpretation to exclude such losses does not have adherence to the letter of the law, which says nothing about this supposed limitation.

Final take

The examples above demonstrate how taxpayers are faced with hidden fictions mostly arising from unclear legal drafting or flawed design of the tax return. The fight human vs machine continues but the reality is that if amendments to the legislation are not made, within a reasonable time, incorrect tax assessments continue to be issued. If we want to contribute to reduce litigation, we need to correct many of these fictions by quick and clear legislative intervention.

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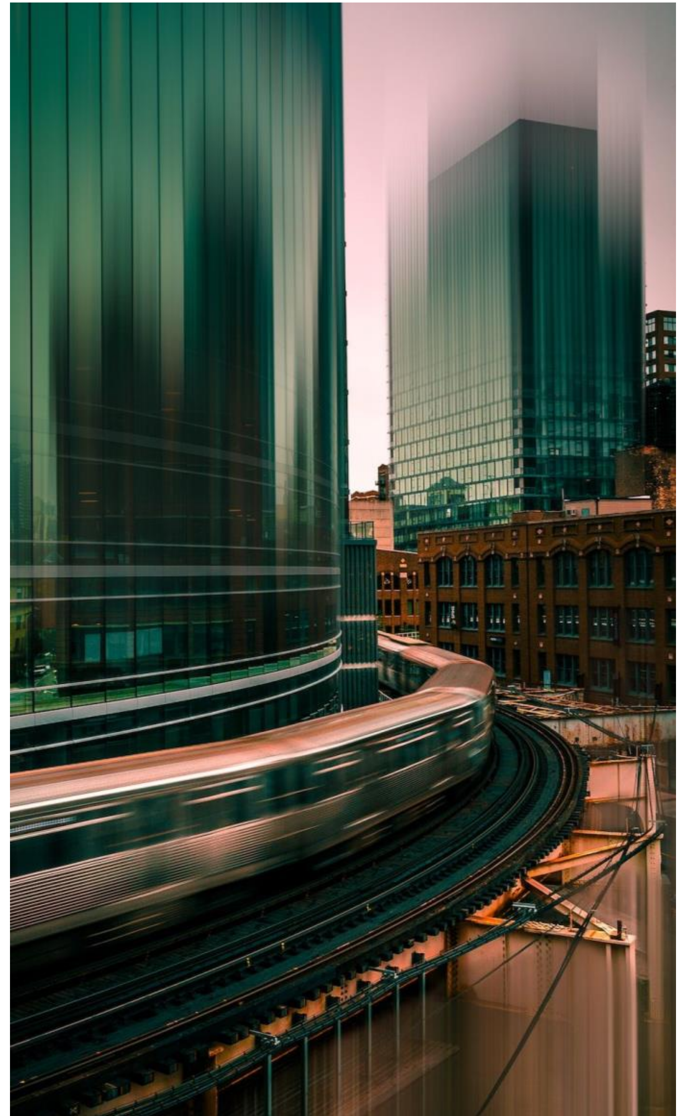

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