

System of Tax Incentives in Research and Business Development. An Analysis of the Recent Case Law of Portuguese Tax Arbitration

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Abstract: The main objective of this work is to analyse the understanding of the tax authority regarding the application of the tax benefit in support of research and development in professional societies and whether this understanding complies with the legal provision. Additionally, to understand the sense of the recent decisions of the arbitral court in this matter. For this purpose, the study applies the legal research methodology. Several legal sources have been analysed, such as the personal income tax law, the corporate income tax law, the investment tax law, administrative doctrine and the jurisprudence of the Portuguese arbitration court. The study shows that the tax authority has been assuming an understanding that does not fit in the legislation currently in force and administrative doctrine concerning tax benefits for the research and development of professional companies. The public authority limits the tax deduction to these entities, and this limitation would not apply in the case of commercial, industrial or service companies. Moreover, the Portuguese arbitral court recently confirmed this discriminatory understanding and agreed with this view. Thus, case law contributes significantly to the clarification of the application of the law.

Keywords: Tax benefits to research and development expenses, Tax policy, Portugal, Professional societies

1. Introduction

The process of innovation and business development is crucial in the life of companies since it allows the development of new products and services relevant to maintaining the company's activity (Ferreira, 2017). It is a matter of tax equity to grant tax benefits for innovation and development, regardless of the company's corporate tax framework. Therefore, the Tax Incentive System for Corporate R&D is an essential instrument allowing companies to recuperate part of their investment in Research and Development projects. This recovery is made within the scope of IRC. In this tax area in Portugal, professional companies are treated differently from companies in the area of industry, services or commerce. The taxation is made on the sphere of the partners under the pretext of avoiding tax evasion and observing tax neutrality. Having a differentiated treatment, they are expected to be not negatively discriminated against when benefiting from tax incentives such as SIFIDE. However, sometimes the legal provisions are not always correctly understood in applying the law, which generates conflicts between companies and taxpayers.

There are few international studies dealing with the tax transparency regime, as far as we know, there are no studies dealing with the applicability of SIFIDE in professional firms. In this sense, analysing the Tax Authority's understanding of applying the tax benefit to support research and development in professional companies and whether this understanding follows the legal provision is important. Additionally, to understand the meaning of the recent decisions of the arbitration court on this matter. For this purpose, legal research is used in order to answer the paper's objective. The use of this methodology in this research paper is appropriate because legal research methodology allows to explore and interpret concepts, theories, principles, and the law's application, including case law analysis. Several legal sources have been analysed, such as the personal income tax law, the corporate income tax law, the investment tax law, administrative doctrine and the jurisprudence of the Portuguese arbitration court. The rest of the text consists of three sections. The first one refers to the literature review and methodology. The following presents the results and their analysis. And finally the third, presents the discussion and conclusions.

2. Literature review and methodology (incentivos fiscais à inovação)

Vishnevsky, Goncharenko, Dementiev, and Gurnak (2022) establish that tax and fiscal policy requirements depend on the life cycle of technologies. In their early stages, they require the most tax support. This support is more important for catching-up countries than for advanced countries, as emerging economies do not have enough experience in promoting technological innovations, relevant institutions and high incomes generated by mature technologies of previous generations. The authors explain that to stimulate new technologies, it is advisable to apply sectoral, system-wide, and matrix.

Gracheva, Artemov, and Ponomareva (2021) study the legal regulation of tax relations in the digital economy, applied to the Russian case. According to the results of the study, it is concluded that it is necessary to ensure the fulfilment of the state's fiscal interests. This requires the transformation of the essential approaches to the legal regulation of tax relations, both in the context of determining the appropriate legal forms to regulate the tax base levied in Russia in the context of the emerging digital economy, and to influence international tax policy in order to use all the advantages provided by international tax cooperation and neutralise the threats caused by international tax competition.

Rosenblatt and Cabral (2017) discusses the applicability of the international tax transparency regime to the taxation of profits earned abroad (CFC Rules regime), analysing its characteristics and its role in the transnational scenario. As a specific objective, the existing conflicts in Brazilian law are examined, due to the adoption of a model different from that practiced worldwide, through taxation on a universal basis, regardless of the availability of profits. The work concludes that the anti-elusive scope of Brazil's international tax transparency regime is just another broad way of taxing income.

Dias and Dinis (2021) critically analyse the legal assumptions of its application, its purpose and the associated constraints. It addresses some of its limitations and inconsistencies, namely the fact that tax transparency is not very attractive to some companies, which seek to free themselves from being subject to this special regime, contrary to the assumptions underlying the creation of the tax transparency regime.

In this conceptual background, this research aims to address one objective: This work aims to analyse the tax authority's understanding of tax benefits for research and development in professional societies and ensure it aligns with legal provisions. It also aims to comprehend recent arbitral court decisions on the matter. In order to answer them, an analysis of the legal structures of Portugal was presented. Portuguese data sources were included: the corporate income tax, the investment tax law, administrative doctrine and the jurisprudence of the Portuguese arbitration court.

3. Results

3.1 Professional companies

Professional companies are those incorporated for the exercise of a professional activity provided for in the list of activities referred to in Article 151 of the personal income tax law, and in which the partners, taxable persons, are professionals in that activity (Sousa, 2023).

Thus, professional societies are legal persons whose main purpose is the common exercise of professional activities organized in a single public professional association. In addition, they are the companies where the formation of profit is made to depend exclusively or almost exclusively on the activities of the respective professional members (Silva, 2023).

Generally the societies of professionals that are subject to public professional associations (professional associations and professional chambers), as is the case of the Certified Public Accountants Association, the Bar Association or the Engineers Association. There are several areas to which a professional company can be associated, such as technical engineering, notary, auditing; architecture, biology, nursing, medicine, veterinary, nutrition, psychology, and soliciting, among others (Esteves, 2019). All these professional societies are subject to the corresponding Professional Associations.

Professional companies are not subject to corporate income tax, except for autonomous taxation. The company's net income (after deductions) is directly imputed to the personal sphere of the partners and is, therefore, taxed under personal income tax (da Costa, 2012). The special regime for professional companies is justified by the human component necessary for developing the activity to the detriment of the capital component (Lopes, 2018).

3.2 The legal framework of the incentive and understanding of the tax authority

The 2011 State Budget Law - Law nº55-A/2010, of December 31, and subsequent amendment in 2013 approved the SIFIDE II to continue increasing companies' competitiveness by supporting their efforts in Research and Development (R&D). Thus, the Entrepreneurial Research and Development Tax Incentives System II (SIFIDE II), in force from 2013 to 2025, aims to support Research and Development activities (Basto & Nogueira, 2021). This incentive includes activities related to the creation or improvement of a product, process, program or equipment which presents a significant improvement and which do not result from simple use of the current state of existing techniques (Ferreira, 2017).

Within the scope of this incentive, the following are considered (1) research expenses are those incurred by the taxpayer to acquire new scientific or technical knowledge, (2) development expenses are those incurred by the taxpayer through the exploitation of the results of research work or other scientific or technical knowledge with a view to the discovery or relevant improvement of raw materials, products, services or manufacturing processes (Santos, 2021).

SIFIDE II can benefit companies (1) resident in Portuguese territory, carrying out, as main business or not, an agricultural, industrial, commercial or services activity and (2) non-resident companies with a permanent establishment in that territory, which have research and development (R&D) expenses (Aldeia, Mota, & Monteiro, 2021).

These supports allow to recover up to 82.5% of the Investment in R&D, in the part that has not been the object of a non-refundable State financial contribution, carried out in the taxation periods from January 1, 2013 to December 31, 2025. Base Rate: Tax deduction applicable to the total expenditure on R&D in the current year - 32.5%; Incremental Rate: 50% of the increase in expenditure over the average of the previous two years (maximum of 1.5M€).

For IRC taxpayers who are SMEs, who have not yet completed two financial years and have not benefited from the Incremental Rate, a 15% surcharge on the Base Rate (47.5%) applies.

However, considering that professional companies fall under the tax transparency regime and therefore benefit from an income tax exemption in the sphere of the company, since the taxation occurs in the sphere of the partners (Nabais, 2021). It has been considered that since there is no calculation of a taxable income, it is not possible to make deductions from this benefit.

Recently, the Tax Administration has been presenting another understanding. Although it is recognized that the expenses incurred are likely to include "research and development expenses", the Tax Authorities consider that the amounts to be deducted in the sphere of the partner, regardless of the corresponding amount, cannot exceed the limit of €1,000 imposed by the personal income tax law. This application criterion hinders the application of the tax benefit in the sphere of the partners due to the existing tax transparency situation. This understanding proved essential for the application of the law and restored justice through the non-negative discrimination of these societies.

3.3 The CAAD court ruling

Decree-Law No. 10/2011, of January 20 and subsequent amendments, approves and regulates tax arbitration as a jurisdictional means of dispute resolution. The Legal Regime of Tax Arbitration (RJAT) has changed with the seventh amendment introduced by article 12 of Law No. 7/2021, February 26. Tax arbitration has its own autonomous and exhaustive regime at the regulatory level. This regime provides for the possibility of resolution, through arbitration, of disputes involving the assessment of the legality of tax acts. In particular, tax arbitration was created to strengthen the effective protection of taxpayers' legally protected rights and interests. Thus, it aims to reduce pendency in administrative and tax courts and provide greater speed in resolving tax disputes.

The CAAD - Center for Administrative Arbitration is an institutionalized center of specialized character and has its competence in tax matters established by the Legal Regime of Arbitration in Tax Matters, approved by Decree-Law No. 10/2011 of January 20. This regime sets the rules for resolving tax disputes through arbitration at the Center. This means of dispute resolution is guided by the principles of celerity, rigor and transparency, which is why it is called to pronounce in tax litigation.

Recently the Portuguese arbitration court was called upon to pronounce the question of the application of tax benefits in these companies.. The CAAD issued an arbitral award in case no. 93/2022-T on September 26, 2022,

with the claimants being the partners of a law firm subject to the tax transparency regime and the defendant being the tax authorities.

The Arbitration Court considered it relevant to clarify whether the deduction of research and development expenses, eligible under SIFIDE II, is subject to the limit established in the Personal Income Tax Law, which provides for an amount of €1,000. This limit is applicable when there is an imputation of the taxable income to the taxable income of the partners of professional companies, under the tax transparency regime.

The arbitrator of the arbitral tribunal considered that even if the income of the partners of the company subject to tax transparency is taxed in the legal sphere of the partners, the tax base is determined under the terms of the corporate tax law. The second law regulates the terms under which the assessment is made and specifies the deductions that can be made from the amount assessed, including tax benefits.

In addition, the Arbitral Tribunal clarifies that the deductions to the collection related to entities subject to the tax transparency regime are imputed to the respective partners or members and, therefore, deducted from the amount calculated based on the taxable income that has taken into consideration for imputation purposes.

4. Discussion and conclusions

The objectives of the tax transparency regime are to combat tax evasion, ensure tax neutrality, and eliminate economic double taxation. Therefore, this regime covers professional companies, implying taxation in the partners' sphere and not the company. Although they constitute an exception to the tax principle of generality, tax benefits have the financial incentive of a certain practice. In this case, encouraging investment in research and development is essential to improve and increase the activity of companies. However, the application applying tax incentives allows the company to reduce tax payable, representing less tax revenue. In this sense, the tax authority takes a limiting position when it comes to using these benefits by company partners. Several doubts have arisen on the benefit of SIFIDE, within the scope of this activity, due to the differentiated interpretation by the tax authority, which eventually led some companies to complain in court. The pronouncement of the arbitral tribunal constitutes an important step in the clarification of the application of the law, namely in the benefit of incentives such as SIFIDE. This study has some limitations, in particular, it only studies the Portuguese case and it analyses the tax and jurisprudential perspective. It would be relevant in future research to develop a multidisciplinary research that involves not only tax aspects but also accounting and commercial. It would also be useful a comparative analysis using other countries.

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