

THE CONSTITUCIONAL DECISION ON THE
2013 STATE BUDGET

TAX & BUSINESS

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I. Introduction

On the 2nd of January 2013, the President of the Republic of Portugal requested the assessment of the Constitutional Court regarding three articles of the 2013 State Budget Law (Law n. 66-B/2012, of 31 December). The President questioned, in particular, the article regarding the suspension of the holiday allowance, or equivalent, paid to civil servants, the article regarding the suspension of the holiday allowance paid to pensioners and the article regarding the imposition of an extraordinary contribution of solidarity to pensioners. Identical assessment requests were submitted by fifty parliament representatives of the Socialist Party, twenty four parliament representatives of the Communist Party, Left Block and Green Party and, except for the article regarding the

holiday allowance, by the Portuguese Ombudsman.

Besides the abovementioned articles, the twenty four parliament representatives of the Communist Party, Left Block and Green Party also requested the assessment of the following articles: the article regarding the salary reduction applicable to civil servants; the article regarding the suspension of the holiday allowance paid to employees subject to teaching and research agreements; the article regarding the payment reduction of overtime working hours to civil servants; the article regarding the taxation of unemployment and sickness allowances; the article regarding the changes made to the Personal Income Tax (“IRS”) progressive tax brackets and the article regarding the 3.5 % IRS surcharge.

On the 5th of April, the Constitutional Court issued Decision n. 187/2013, which declared the unconstitutionality of the articles of the 2013 State Budget

Law regarding the suspension of the holiday allowance or equivalent paid to civil servants, to pensioners and to employees subject to teaching and research agreements, and regarding the taxation of unemployment and sickness allowances.

II. The suspension of the holiday allowance

As it occurred with the 2012 State Budget Law, the 2013 State Budget Law also determined the suspension of the holiday allowances paid to civil servants, to pensioners and to employees subject to teaching and research agreements.

As it also occurred with the 2012 State Budget Law, the 2013 State Budget Law was, in this part, considered unconstitutional due to the violation of the principle of equality. In fact, the Constitutional Court considered that the sacrifices imposed on civil servants are in breach of the principle of equality, since no equivalent sacrifices

are imposed to the private sector employees. Although recognizing that broader tax measures were adopted affecting the private sector employees, the suspension of the holiday allowance payment, together with the salary reduction applied to civil servants, was considered to be in breach of the principles of equality and proportionality and of the fair distribution of public burdens. The abovementioned Decision also considered that the suspension of the holiday allowance payment to civil servants cannot be justified based on the country's economic situation.

As regards the unconstitutionality of the suspension of the holiday allowance payment to pensioners, the Constitutional Court sustained that the violation of the principle of equality results from the comparison of the pensioners sacrifices with (i) the civil servants sacrifices - considering the fact that civil servants suffer the reduction of salaries plus the suspension of holiday allowance, but

are not subject to the extraordinary contribution of solidarity -, with (ii) the sacrifices of the taxpayers that are not subject to any of these measures, and (iii) with the situation of pensioners that are subject to the extraordinary contribution of solidarity, but not covered by the suspension of the holiday allowance payment, since they don't integrate the public social security system. The abovementioned Decision also held that the subtraction of only 90% (not 100%) of the holiday allowance payment to pensioners does not outweigh the fact that, given the cumulative effect of all the measures that have been applied to pensioners (suspension of holiday allowance payment, extraordinary surcharge and extraordinary contribution of solidarity), they were subject to a greater sacrifice than civil servants.

III. Taxation of unemployment and sickness allowances

The 2013 State Budget Law also established that unemployment and

sickness allowances are now subject to a 5% and 6% contribution.

The Constitutional Court declared the unconstitutionality of this taxation, since it could lead to a situation where the sickness and unemployment allowances could be inferior to its minimum legal limit (in case of unemployment allowance, the daily amount cannot be less than 30% of the daily value of the minimum wage established for the sector of activity of the beneficiary and, in case of sickness allowance, the daily amount cannot be inferior to € 419.22, which corresponds to the value of the social support index).

In fact, the Constitutional Court referred that this taxation collides with the constitutional principle of proportionality, since these contributions do not ensure the minimum necessary conditions that, according the legislator, cannot be denied to the beneficiary, specially taking into consideration that such

beneficiary is in a situation of special vulnerability due to the lack of labor income fundamental for the vital family needs.

IV. Extraordinary Contribution of Solidarity

As regards the extraordinary contribution of solidarity, due by pensioners, the 2013 State Budget Law determined the extension of its incidence to pensions higher than € 1.350, to pensions paid by public entities and to all the lifetime cash benefits payable under any title to pensioners, pre-retirees or similar.

Applicants in favor of unconstitutionality sustained that the extraordinary contribution of solidarity is in breach of the principle of the personal income tax unity, on the grounds that this contribution reflects a fragmentation of the personal income taxation with severe tax increases for certain categories of citizens. In addition, the applicants in favor of

unconstitutionality also referred that the extraordinary contribution of solidarity is in breach of the principle of equality and proportionality, since this contribution is levied on a specific category of people by virtue of criteria related to their condition or status of labor inactivity, instead of the ability-to-pay constitutional criterion, thus discriminating negatively and disproportionately and without constitutional justification, the pensioners, in relation to active workers. It was also upheld that the extraordinary contribution of solidarity violates the principles of protection of legitimate expectations and equality before the public burdens, since it constitutes a discriminatory differentiation of pensioners in sharing burdens with the reduction of the public deficit, and, also, the principle of private property.

The Constitutional Court sustained the unconstitutionality of this contribution, by saying that, this is a social security contribution, distinct from the strict

tax conception, both on the objectives, and on the legal structure, it is a detained revenue as it is intended to meet the specific needs of sub-contributory social security system which is not subject to the general tax principles of unity and universality.

The abovementioned decision also states that the violation of the principle of proportionality and the principle of protection of legitimate expectations is not at stake, since this contribution is an exceptional and transitional measure and provides the required degree of sacrifice to pensioners, through the application of progressive rates excluding those whose pension is less than € 1.350.

Thus, the Constitutional Court considered that the extraordinary contribution of solidarity corresponds to an extension of the salary reduction measure that is applied to civil servants, not being considered by the said Court as disproportionate or excessive.

Finally, the Constitutional Court held that this contribution helps to finance the social security system, relying on a consistent rationality of an operational strategy that fits within the legislator's freedom of interpretation.

V. amendments to IRS brackets

The 2013 State Budget Law reduced the number of taxable income brackets, from eight to five and increased the rates (normal and average rates) applicable to each taxable income bracket.

It was held by the claimants that these brackets reductions are in breach of the principle of progressivity, since they reduce the IRS taxation progressivity as established in the Portuguese Constitution.

The Constitutional Court determined that such rule is not unconstitutional,

given that, despite the reduction, the brackets still take into account the different income levels providing a considerable degree of progression. In fact, said Decision sustained that the tax progressiveness of IRS is guaranteed by the distribution of taxable income for a significant number of brackets. The income tax rates will be as high as higher the taxable income is, thus ensuring the progressive nature of taxation.

VI. reduction of tax deductions

The 2013 State Budget Law imposed rules which determined the reduction of the tax deductible amounts regarding health, education and training expenditures, expenditures related to maintenance payments, expenditures on housing for disable people, real estate and new equipment of renewable energy, as well as, the reduction of expenses incurred with real estate. The claimants stressed that these reductions are in breach of the ability-to-pay principle, which is related to the

principle of tax equality and the principle of family consideration for tax purposes.

However, the Constitutional Court considered that these reductions are not in breach of any Constitutional principle. Although the Court considered that such reductions affect the tax capacity of families and taxpayers, it also considered that such reductions have arisen in a context of generalized increases of tax under which the taxpayer is required to participate in the satisfaction of public burdens. In this sense, the Constitutional Court argued that these reductions specially affect the taxpayers with higher income, who are, in principle, able to support it. Finally, the Constitutional Court considers that the principle of tax capacity is a regulator of the tax system, without a specific embodiment, particularly, in respect to the quantification of deductions and of its limits, so that it fits within the legislator's freedom of interpretation.

VII. The IRS Surcharge

As regards the IRS surcharge, it was sustained that it was in breach of the principle of the personal income tax unity, since such surtax is in fact a new personal income tax, with different withholding rules than those established for the IRS. This surcharge is levied on the proportion of 3.5% of all income, thus being in breach of the principle of the personal income tax unity and of the principle of the progressiveness of tax.

The Constitutional Court determined that the surcharge is not in breach of the principle of tax unity, since this principle only determines that all personal income must be gathered in a single tax base incidence. In addition, the Court stated that, despite the differences regarding withholding rules, such differences reveal the exceptional and transitional nature of the surcharge, motivated by the current financial situation of the State. On the

other hand, despite the acknowledgment that the surcharge is not completely coherent with the logic of progressivity, the Constitutional Court considered that the surcharge has a minimum of progressiveness, since its legal regime establishes an exemption up to the limit of the annual amount of the minimum guaranteed monthly remuneration. Therefore, the subtraction of the exempt amount to the taxable income, for the purpose of calculating the taxable amount, confers to the surcharge a minimum of progressivity.

VIII. Labor income and Pensions vs. Capital Income

The unconstitutionality of the different tax treatment between labor income and pensions and capital income was also claimed, since the 2013 State Budget Law established that the tax rates on labor income and pensions may be higher than 50%, while capital income is taxed by a single withholding tax rate of 28%. According to the

constitutional assessment request, this difference would undermine the principle of equality in the distribution of public burdens and the principle of fair taxation.

The Constitutional Court referred that the abovementioned difference is not in breach of any constitutional principle, by considering that said comparison shall not be sustained. In fact, the Court sustains that in addition to the fact that the income is not calculated in the same way, the nature of said tax rates and its *modus operandi* do not allow for a comparison based on the nominal value. The Court also sustained that these tax rates correspond to mechanisms with different operating logics (progressive vs. proportional) and therefore differently materialize the distribution of the tax burden: the general rates are based on personal taxation logic, while withholding or autonomous rates correspond to a real taxation.

IX. Conclusions

Despite taking into account the state of emergency that the country is now facing, the Constitutional Court considered that some of the rules under assessment are in serious breach of the constitutional principles and cannot be part of the Portuguese juridical-constitutional system.

In respect of the legal effects of this Decision, unlike what happened in relation to the Court's judgment regarding certain rules of the 2012 State Budget Law, the decision under examination determined that the declaration of unconstitutionality of these rules are generally binding, thereby producing effects since the entry into force of the rule declared unconstitutional (i.e., from January 1, 2013) and determining the reinstatement of the rules that were eventually revoked. Such declarative effect implies that the constitutional decision is not innocuous, being

estimated at, at least, € 1.326 million (€ 1.174 million regarding the rules on holiday allowances and € 152 million regarding the rules on the contribution levied on sickness and unemployment allowances).

The Government should now move forward with alternative measures in order to rectify or mitigate the referred negative effect of the Decision in the State Budget of 2013. Since it was already announced that such alternative measures shall not mean another tax increase, but rather the reduction of public expenditure, it is expected that the Government undertakes measures that severely restrict expenditure - Dispatch no. ° 47/2013/MEF, of 8 April, issued by the Minister of Finance has already determined the prohibition of entering into new administrative expenses without the prior authorization of the Minister of Finance - and may amend the requirements to access Social Security pensions, namely, by raising the retirement age.

The logo consists of the letters 'RFF' in a bold, white, sans-serif font. The 'R' is slightly larger and positioned to the left of the two 'F's.

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Lisbon, 17 April 2013

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