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### **Judicial Proceedings And Tax Advantage**

Frequently companies submit proceedings to judicial courts with the objective to mitigate the loss resulting from bad debts arising from the sales of goods and services, by recovering the VAT paid in advance to the State.

Presently, under the terms of article 71 of the Value Added Tax Code (VATC), a VAT subject may deduct the VAT in respect of bad debts in a judicial lawsuit, or credits detained regarding insolvents, after the insolvency is determined by court order, without prejudice of posterior payment of the VAT in case such credits are totally or partially recovered.

The bad debts must result from the following judicial proceedings:

- a) Insolvency proceedings: in order to recover the VAT regarding bad debts, it is necessary a judicial order, stating the insolvency of the debtor.
- b) Enforcement proceeding: in order for a VAT subject to recover the VAT in respect of bad debts, it is necessary to demonstrate the impossibility to recover the debts, i.e., a court certificate proving the non-existence of assets.

Under paragraph 9 of article 71, of VATC, entities that are subject to VAT, may deduct their tax liabilities in respect of bad debts, when the following conditions are met:

- Outstanding debts in the amount of up to €349,16 (VAT included) owed for more than 6 months by natural or legal persons or entities engaged in VAT exempt trade and not entitled to tax deduction rights.
- Outstanding debts in the amount between €349,16 and €4.987,98 (VAT included) subject to a court order acknowledging the existence of such debts and owed by natural or legal persons or entities engaged in VAT exempt trade and not entitled to tax deduction rights.
- Outstanding debts in the amount of up to €4.987,98 (VAT included) when (i) debtors are entitled to deduction rights and the debt was acknowledged by a court order or (ii) if the debt was claimed at an enforcing proceeding and the debtor could not be served.

Under the terms of paragraph 10 of article 71 of VATC, the global amount of the credits; the total tax liabilities to be deducted; recovery actions by the creditor; and the total of partial failure of the actions referred to in paragraph 9 of article 71 of VATC must be certified by an auditor.

Beyond VAT, a judicial proceeding may also carry tax benefits, in respects of income tax. In fact, under the terms of paragraph 1 of article 34 of the Companies Income Tax Code (CITC), it is possible to account the provisions set aside for doubtful debts as an expense.

For the purposes of these deductions, under paragraphs 1 and 2 of the article 35 of CCIT, the following credits may be considered as bad debts:

- When the debtor is subject to recovery or insolvency proceedings;
- When the debt has been claimed through a court proceeding;
- When the debt is due for more than 6 months and there are evidences showing that measures were taken to recover such debt. For these purposes the accumulated annual amount of the provisions to account for bad debts may not be higher than:
  - a) 25% for debts due for more than 6 and up to 12 months;
  - b) 50% for debts due for more than 12 and up to 18 months;
  - c) 75% for debts due for more than 18 and up to 24 months;
  - d) 100% for debts due for more than 24 months.

From the application of the current legislation it can be seen that judicial debts recovery represents the majority of the legal proceedings pending in Civil Courts. In view of the aforementioned, the government is willing to modify the tax regime on the outstanding debts as part of its plan to decrease the pending proceedings in Courts.

The Council of Ministers passed a legislation proposal to improve the efficiency of the judicial system, pertaining to VAT recovery and tax deduction of outstanding debts. In short the government will grant tax advantages to whoever withdraws court proceedings regarding bad debts, with the purpose of decreasing the number of pending court proceedings.

In respect to tax issues, the government is expected to approve during this year the necessary acts and regulations in order to guarantee that:

- The tax deduction of credits up to a certain amount claimed in court and which have not been concluded for over a year, is permitted once the creditor withdraws the pending court proceedings;
- The concept of bad debt for VAT purposes is extended from €4,987,98 to €14,963,94 euros, without the need for the bad debt to be confirmed as such during an enforcement or bankruptcy proceeding.

The above mentioned measures are set forth in the Ministers Council resolution number 100/2005 which includes the government's plan to decrease the pending proceedings in the courts. In respect to tax issues, the acts and regulations to be approved will consider several aspects concerning personal income tax, CITC and VAT, therefore harmonising and adapting the new measures with the existing legal regimes.

The companies which after a year still have pending court proceedings up to an amount to be set forth and withdraw their claims, may immediately recover the VAT. For CITC purposes, it is also foreseen that the totality of bad debts is immediately accounted for as an expense. This being the case, nothing will be claimed to the debtor, leaving national treasury burdened with unpredictable amount.

Another measure taken for the same purposes, which has been in force since September 15, 2005, with the entering into force of the decree law 107/2005, dated of July 1, is the enforcement department ("secretarias de injunção") extension of competence. Therefore, creditors are now able to seek judicial confirmation of debts arising from the non compliance of agreements in the amount of up to €14.963,94, before the enforcement department and request the reimbursement of the VAT regarding such bad debts and without previously filing for court proceeding.

These measures - making the courts swifter and benefiting the companies - will prevent the National treasury from cashing in millions of Euros in VAT: the companies selling products or rendering services issue the respective invoices and deliver the respective VAT to the State, counting on being paid that amount by the client. But if the client fails to pay the creditor (company) will suffer a loss instead of making a profit. By ceasing the court proceedings against the debtor (client), the company can at least recover the amounts regarding the VAT paid to the State

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**Abreu, Cardigos & Associados – Sociedade de Advogados R.L.**

**Av. das Forças Armadas, 125-12º**

**1600-079 Lisboa**

**Tel: 351 21 723 18 00 - Fax: 351 21 723 18 99**

**[www.abreucardigos.com](http://www.abreucardigos.com)**