Francisco de Sousa da Câmara*
and José Almeida Fernandes**

Corporate Loss Utilization through Aggressive Tax Planning

1. Introduction

Portuguese tax rules concerning corporate loss utilization have been subject to significant amendments, which were essentially aimed at restricting the possibility for corporations to deduct these losses from their taxable income. Recently, the Portuguese parliament introduced new rules aimed at partially restricting the possibility to deduct capital losses in a series of transactions. Moreover, mandatory disclosure of aggressive tax planning schemes involving the use of tax losses has been requested by the tax authorities and, starting in 2012, no more than 75% of taxable income may be offset by losses, such that all companies with taxable income must subject 25% of such income to tax regardless of whether they still have loss carry-forwards from previous years.

Nevertheless, according to the latest public data (the most recent statistics released for the period 2007-2009), the amount of corporate losses being declared by corporate taxpayers has risen in the last three fiscal years. The amount of tax losses declared jumped from EUR 127.683 million in 2007, to EUR 140.924 million in 2008 and to EUR 146.706 million in 2009,[1] which represents an increase of 10% between 2007 and 2008, and of 4% from 2008 to 2009. The increase of total tax losses was not accompanied by a significant decrease in reported taxable profits, which remained stable during the same period (EUR 208.040 million in 2007, EUR 200.598 million in 2008 and EUR 203.672 million in 2009). The numbers seem to imply that the increase in the amount of tax losses has also been a factor in justifying the introduction of further restrictions on their deductibility under Portuguese tax law.

The Portuguese tax authorities have also been actively contesting, in tax audits, losses accounted for by taxpayers. Notably, in cases where changes in ownership or a reorganization occur, the amount of losses that may be carried forward or transferred is subject to strict scrutiny and usually contested. The focus of the tax authorities on this area is evident. Therefore, it is not surprising that out of 13 disclosed schemes that may potentially be regarded as aggressive tax planning according to the tax authorities, four of those schemes deal precisely with transactions aimed at using existing corporate losses.

The OECD report *Corporate Loss Utilisation through Aggressive Tax Panning* (OECD 2011) highlights in its chapter "Schemes Involving Tax Losses" some types of transactions that can potentially lead to an abusive use of tax losses. The current Portuguese tax law rules (e.g. dealing with losses in a corporate reorganization context) and the existing mandatory rules on aggressive tax planning involving the use of losses seem to grant legal tools for use by the tax authorities to curb transactions that unlawfully aim at using losses, a conclusion that can be drawn for the analysis conducted in the course of this article.

2. Current Portuguese Tax Regime

Ordinary losses are deductible from a corporation's taxable income for corporate income tax purposes. The deductibility of losses incurred by a corporation is subject to a business purpose test, as losses may be deducted only if they were incurred for the purpose of generating taxable profits. Furthermore, losses must be properly documented.

From 2012 onwards, ordinary losses may be carried forward against taxable profits for a five-year period. Nevertheless, taxpayers should be aware that losses incurred in previous fiscal years are subject to different carry-forward periods,[2] namely a four-year period for tax losses registered in 2010/2011 and a six-year period for tax losses registered in 2009 or before. Therefore, theoretically, losses with three different periods might coexist simultaneously for fiscal years starting in 2012, which requires taxpayers to have a separate tax accounting for losses carried forward.[3] Currently, there are no express rules determining the order of priority in which losses are to be deducted, but it has long been understood that a FIFO rule should be applicable, as practice shows, including in presenting tax returns (mod. 22).

In 2012, the Portuguese parliament also revoked with retroactive effect a rule that was in force solely in 2011 whereby corporations with losses in two consecutive fiscal years would be obliged to have such losses certified by an auditor in order for the deduction thereof in the third year to be allowed. The role of the auditor in certifying the tax losses was said to be controversial, and the value of such certification uncertain in legal terms, while gener-

* Partner, Morais Leitão, Galvão Teles, Soares da Silva & Associados; Visiting Professor of International Tax Law, Universidade Nova de Lisboa and of Tax Law at Universidade Católica Portuguesa.

** Senior Tax Lawyer, Morais Leitão, Galvão Teles, Soares da Silva & Associados.

1. *See* statistical data available on the website of the Portuguese tax authorities at http://info.portaldasfinancas.gov.pt/pt/dgci/divulgacao/estatisticas/estatisticas_ir.

2. *See* Tax Authorities Binding Ruling 1658/2010 (12 August 2010), duly sanctioned by the Secretary of State for Fiscal Affairs.

3. The different periods for carry forward of losses might also have implications for the statute of limitations for the tax authorities to determine assessments regarding previous fiscal years. If losses were deducted by the taxpayer rather than applying the general four-year period, the statute of limitations will correspond with the applicable carry-forward period.

ating additional costs for corporations in the midst of the economic crisis, especially for small and medium-sized enterprises that were not required to have their accounts audited.

Portuguese tax rules also feature a special provision under which existing loss carry-forwards expire where there is, prior to the fiscal year in which the loss would be deductible, a change in the corporate purpose or the nature of the activity of the company, or at least 50% of the capital or the majority of the voting rights has been transferred.[4] Taxpayers might request authorization from the Ministry of Finance prior to the occurrence of any of the events described above in order to avoid the deemed expiration of losses. Such authorization is granted in "special cases" under the condition that the taxpayer be able to prove the "recognizable economic interest" (*reconhecido interesse económico*) of the event that triggered the need to seek such authorization.

Moreover, the tax authorities have issued binding rulings where the requirement to present the authorization is waived and the corporations may nevertheless carry forward losses where a change of at least 50% of the capital or the majority of the voting rights occurs if "the new stockholders already had the control of the majority of the corporation's capital" and the change results from a restructuring that benefited from the tax deferral regime under the Corporate Income Tax Code (*Código do Imposto sobre o Rendimento das Pessoas Colectivas*, CIRC) for reorganizations[5] or the change from indirect control to direct control and vice versa.[6]

From the wording of the tax law provision, it is unclear whether the corporation or its stockholders are responsible for presenting the authorization request. This lack of definition seems to stem from the fact that the rule implies that both the corporation itself and the shareholders have a common interest in the use of the losses, which leads to difficulty in assessing in which case and what taxpayer is most affected by the deemed expiration of the losses.

There are several specific rules dealing with its deductibility of capital losses. For instance the deductibility of losses is generally restricted to only 50% if a net capital loss is realized on the sale of shares or other corporate rights. The same 50% restriction on the deductibility of capital losses also applies to decreases in net worth or other negative equity variations associated with shares or other items of a company's equity (e.g. supplementary capital contributions).

Regarding the computation of the net capital loss realized by taxpayers where a shareholding is concerned, the amount of dividends received by the said taxpayer that are eligible to benefit from the domestic regime for the elimination of double taxation in the preceding four fiscal years should be deducted from such loss (i.e. such amounts are not deductible for tax purposes). Before the introduction of such a specific provision in the CIRC, the tax authorities in the past used the general anti-avoidance rule to counter transactions where a distribution occurs before the winding-up of the distributing corporation which results in a capital loss.

Capital losses will be totally disregarded for tax purposes if they are incurred concerning corporate rights that (1) have been held for less than three years and were acquired from a related party or a resident of a listed tax haven or the free-trade zones of the Azores and Madeira or (2) are sold to a related party or a resident of a listed tax haven or the free-trade zones of the Azores and Madeira. Taxpayers have been arguing that where transactions with related parties occur, a deduction of capital losses should be allowed if proof is offered that such transactions were in line with the arm's length principle and that they complied with applicable transfer pricing rules. Otherwise the rule would be equivalent to a legal presumption, which might be considered to be contradictory with the purpose of these types of transfer pricing rules and constitutional principles.

Losses arising from the liquidation of corporations are also subject to specific rules, which basically require (1) a minimum holding period of three consecutive fiscal years before the date of winding-up and (2) that the liquidated company was not resident in a low-tax jurisdiction, in order for any losses to be deductible for tax purposes.

Regarding losses in the context of a corporate tax group, there are also several specific restrictions, namely: (1) tax losses incurred in a fiscal year before a corporation has joined the group are deductible from the group's taxable income only up to the amount of taxable income of that same corporation; and (2) if a corporation leaves the group, any losses incurred during the period that it was part of the group are extinguished.

Finally, regarding reorganizations, the possible transfer of losses is subject to a specific authorization by the Ministry of Finance. This authorization is dependent upon the taxpayer proving that the reorganization is carried out for "valid commercial reasons" (*razões económicas válidas*) and part of a medium/long-term strategy of business development with positive effects on the productive structure. The Ministry of Finance may establish in such authorization a specific plan for the deduction of losses, setting limits on the amounts that may be considered in each fiscal year.

The tax authorities have generally used more strict criteria for allowing the transfer of losses in the context of a reorganization than to concede that the requirements for the

4. For corporate income tax purposes, taxable events are presumed to occur on the last day of the applicable fiscal year (*see* Art. 9°, no. 8 Corporate Income Tax Code, *Código do Imposto sobre o Rendimento das Pessoas Colectivas*), and thus it seems that where an event takes place that is capable of determining the expiry of the losses carried forward, no losses may be deducted in such year. However, it seems that if the relevant date for the expiry of losses is determined specifically in tax law (e.g. the date of change of ownership), it is debatable whether any pro rata allocation should be used that would still allow the partial offsetting of profits with existing losses.
5. *See* Tax Authorities Binding Ruling 104/2006 (1 April 2006), duly sanctioned by the Secretary of State for Fiscal Affairs.
6. *See* Tax Authorities Binding Rulings 2370/2006 and 2539/2006, sanctioned on 29 October 2008 and 27 October 2008 respectively, by the legal substitute of the Director-General.

application of the neutrality regime for a reorganization were duly met. The fact that both require first and foremost that the reorganization be based on "valid commercial reasons" seems to imply that the same result should be reached in both situations, but that has not been the case and support might be sought in the fact that additional requirements are established in the letter of the law. Nevertheless, the tax authorities have not yet established clear guidance on their analysis of what such additional requirements imply and where they differ from the "valid commercial reasons" test, namely whether if in the context of losses this concept should be interpreted differently from what it means in the context of a reorganization.

The Portuguese *Foggia* case (C-126/10), which was recently decided by the European Court of Justice (17 November 2011), is a clear example of the statement above. The fact that a reorganization was said to be carried out for "valid commercial reasons" (i.e. it was understood that the merger by incorporation of three holding corporations of a Portuguese bank into another corporation (Foggia) had a positive effect in terms of the overall cost structure of the group, as it would allow a reduction of administrative and management costs) was not sufficient for the transfer of losses to be allowed by the tax authorities.

In this case, the tax authorities did not assert that the concept of "valid commercial reasons" itself was capable of being interpreted differently in the context of a request concerning a transfer of losses, but merely stated in general that the requirements for such approval were more stringent than those for the application of the special tax neutrality regime for reorganizations. Among the reasons that led the tax authorities to deny the authorization of the transfer of losses were that (1) the acquiring corporation had developed almost no activity as a holding, (2) it had no financial holdings and its net value was almost irrelevant when compared to that of the acquired corporations and (3) the positive effects of the merger were insignificant from the perspective of the acquiring corporation (*Foggia*).

The European Court of Justice found not to be decisive by itself "the fact that on the date of the merger operation, the acquired company was no longer carrying out any management activity, that it no longer had any financial holdings and that the acquiring company intended to take over the acquired company's losses which had not yet been exhausted for tax purposes", which are facts that nonetheless might still allow that a reorganization might be said "to have been carried out for valid commercial reasons".[7] However, the Court also considered that "the fact that those tax losses are very substantial and that their origin has not been clearly determined may constitute an indicator of tax evasion or avoidance, where the operation of merger by acquisition of a company without contribution of assets is aimed only at obtaining a purely tax advantage",[8] and that per se is not enough for fulfilling the "valid commercial reasons" test. This is due to the fact that "the cost savings resulting from the reduction of administrative and management costs, when the acquired company disappears", are a type of cost savings "inherent in any operation of merger by acquisition as this implies, by definition, a simplification of the structure of the group".[9]

The *Foggia* case will now once again merit a reappraisal by the Portuguese courts in order to determine whether the facts of the case allow for the deemed fulfilment of the concept of "valid commercial reasons" in accordance with the line of reasoning of the European Court of Justice. The final decision in the case might allow further clarity as to how the Portuguese courts interpret both the concept of "valid commercial reasons" and the requirements for the transfer of losses within a reorganization.

3. Mandatory Disclosure of Aggressive Tax Planning Schemes Dealing with Corporate Losses

In 2008, the Portuguese parliament approved a regime of disclosure obligations to curb aggressive tax planning which focuses on the definition of "tax planning schemes" and on the disclosure obligations for the proponents of the schemes or their users, as well as on the fines and penalties that may be applied if the disclosure rules are not respected.

A tax planning scheme is defined as any operation, plan, project, proposal, opinion or recommendation, expressly or implicitly given, whether or not materialized in agreements, deals, or corporate structures; as well as any act to be performed, in performance or already performed, aimed at obtaining solely or as its main purpose the reduction, avoidance or deferral of taxes due or the obtaining of a tax benefit that would not be obtained, totally or partially, without the use of the scheme.

The disclosure obligations are triggered in the case of schemes that involve net operating and capital losses, which highlights the concern of the tax authorities with tax planning for corporate loss utilization by defining it as an hallmark of what is potentially considered abusive.

According to the available data, after the regime entered into force and with approximately 80 disclosures between 2008 and 2010, the tax authorities released in 2010 a list of 13 schemes considered potentially abusive and to which would possibly be deemed applicable the anti-abuse provisions to counter intended tax consequences. Of these 13 schemes, four deal with the use of corporate losses.

The first scheme identified by the tax authorities as potentially triggering the application of the general anti-abuse rule[10] deals with the transfer, by a corporation with loss

7. *See* PT: ECJ, 10 Nov. 2011, Case C-126/10, *Foggia – Sociedade Gestora de Participações Sociais SA v. Secretário de Estado dos Assuntos Fiscais*, paras. 38-40, ECJ Case Law IBFD.
8. *See* C-126/10, para. 42.
9. *See* C-126/10, para. 48.
10. The Portuguese general anti-avoidance rule entered into effect in 1999, and the current version reads as follows: "[J]uridical acts or agreements do not produce effects for tax purposes, when it is evidenced that they were performed by artificial or fraudulent means and abuse of legal forms, with the sole or principal objective of reducing, eliminating or deferring the taxes that would have been payable if juridical acts or agreements of equivalent economic results had been pursued, or with the purposes of

carry-forwards about to expire by virtue of reaching their temporal limit, of a branch of activity at its market value to another corporation, which immediately enters into a service agreement with the selling corporation (as it does not have the necessary resources to develop such activity). The selling corporation will offset the taxable income that it has to recognize from the sale with the losses carried forward. The acquiring corporation will benefit from the depreciation of the assets of the branch of activity valued at its market value.

The second scheme dealing with corporate losses concerns the situation where a multinational enterprise intending to acquire an operating company in Portugal first sets up a Portuguese holding corporation that enters into a loan agreement with a banking institution to acquire the first corporation. After acquiring such corporation, the holding company incorporates by a merger the operating company to be able to offset the business profits with the financial costs borne from the loan agreement. The understanding of the tax authorities is that the deduction of such costs might be countered by denying the deductibility of the financial costs by resorting to the general business purpose test for its deduction or the general anti-avoidance rule.

The third scheme relates to the securitization of future receivables through the issuance of bonds that might be acquired by a financial institution or a related entity of the corporation that acts as the originator. The originator corporation will thus register taxable income from the sale of such receivables at the time of their sale, and hence use loss carry-forwards to avoid tax on the profits realized from such sale. The tax authorities believe that such sale and its intended tax consequences in the context of a securitization might be countered with the application of the general anti-avoidance rule or by denying the application of the specific tax regime established for securitization transactions.

The fourth scheme dealing with the use of corporate losses concerns the donation of immovable property by stockholders to a corporation at its market value. The positive equity variation (*variação patrimonial positiva*) registered by the corporation and recognized for tax purposes as a profit is offset by the use of existing corporate losses and by the depreciation of the asset at its market value at the time of the donation and onwards. The tax authorities believe that the general anti-avoidance rule is potentially applicable to such transactions, and as such is capable of denying the tax treatment sought by taxpayers.

In these four schemes identified by the tax authorities as being potentially regarded as aggressive tax planning, it seems that the use of existing corporate losses or those about to expire is the only motive for entering into the described transactions – which does not appear surprising because the fact pattern arises from transactions that were notified under the disclosure obligations that require that they are "aimed at obtaining solely or as its main purpose the reduction, avoidance or deferral of taxes". The schemes were publicly announced without a series of relevant facts to support the view of the tax authorities of these strategies being outright considered as potentially abusive and hence subject to the application of the domestic anti-avoidance provisions (e.g. the Portuguese general anti-avoidance rule).

Nevertheless, there are business reasons that might sustain that – albeit faced with a similar fact pattern – taxpayers elect to enter into the transactions and hence do not apply then for tax abuse purposes. In such cases, the application of anti-abuse provisions might not be lawful, and as a result a case-by-case analysis is required to determine whether there is a risk of a transaction being regarded as abusive tax planning.

4. Conclusion

Portuguese tax legislation has been consistently subject to amendments aimed at restricting the possibility of corporate taxpayers to deduct losses, which has been seconded by the stance of the tax authorities in tax audits to aggressively pursue adjustments to the losses reported by taxpayers and the possibility to carry forward such losses.

The transfer of losses has also been severely restricted with the introduction of rules that require authorization, in which cases the tax authorities benefit from some discretion in deciding where such transfers are indeed allowed.

Recently, the mandatory disclosure rules also allow the tax authorities to counter purely tax-motivated schemes that aim to use tax losses by applying the existing anti-abuse rules under Portuguese tax law, with the benefit of early detection of abusive tax planning and by publicly drawing attention to their understanding of the tax treatment of those transactions to deter the use thereof by taxpayers.

Existing Portuguese tax rules on the deduction and transfer of losses, as well as the disclosure rules (taking into account the type of schemes announced as a result of the reports received) seem to allow the countering at an early stage of some of the types of transactions highlighted in the OECD report on corporate loss utilization through aggressive tax planning", namely some of those already identified relating to "corporate reorganizations", "schemes shifting profits to a loss-making party" or "schemes circumventing time restrictions on the carry-over of losses".[11]

However, currently there is still a lack of clear guidance from the tax authorities for a proper understanding of where to draw the line in the lawful use of existing tax losses to offset

obtaining tax advantages that would not be achieved, totally or partially, with the use of those means; in such cases, the taxes will apply as if those means and forms were not used and no advantage would apply either" (authors' translation).

11. *See* OECD Ctr. for Tax Policy and Admin., *Corporate Loss Utilisation through Aggressive Tax Panning* (OECD 2011), at 49-54.

taxable profits where a change of ownership or a reorganization occurs, especially with regard to how to construe the "valid commercial reasons" test, and the further requirements on what constitutes a positive impact in the productive structure of a corporation.

Although the need to curb purely tax-motivated transactions for the transfer of losses should be actively pursued by both the parliament and competent authorities, the new rules and the orthodox stance of the tax authorities has in many cases prevented actual operating losses from being used. This result undermines the constitutional principle of corporations being taxed on net profits (*lucro real*) and affects investment decisions due to the inability of corporations to use the losses incurred in early stages of their investments to offset future profits. In the end, this results in an additional cost that acts as a disincentive to new investments by taxpayers.