Portugal

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Summary and conclusions

In Portugal the topic of foreign exchange (FX) fluctuations has not received significant attention either from the tax legislation or from the academic literature. In fact the Corporate Income Tax Code currently does not include any specific provision dealing with currency translation in the computation of income of resident taxpayers, except for the reference that FX gains or losses as registered in company accounts are to be considered, respectively, as tax profits or expenses.

Due to the overlap between accounting and taxation (the computation of income for tax purposes generally follows the financial accounts), issues concerning FX fluctuations are dealt with primarily under the applicable accounting standards.

In general, the tax treatment follows the accounting treatment as to the timing of income or expenses recognition, including FX gains or losses. Since the adoption of the euro, income may only be computed and reported in the accounts and tax return in euro. As regards the actual translation of the currency fluctuation, FX gains or losses are computed under Portuguese law on a per event basis. Generally, all realized exchange differences on monetary items are recognized in the profit and loss account on an accrual basis.

As regards recognition principles, the Portuguese rules establish that FX elements of a transaction are treated as separate taxable objects, i.e. the taxpayer may realize a profit with a sale of a product in a foreign currency and a loss in the translation of the foreign currency into domestic currency, as a consequence of the time gap and FX differences between the registration in the accounts of the operation and its payment. As such, gains or losses are, as a rule, recognized as an ordinary gain or loss relevant to determine the taxable profit of the year.

At the present stage, Portugal corporate tax law does not draw any specific distinction between the character of the FX gain or loss as capital or income. This is an area where an amendment/clarification would be welcome in order to extend the FX gain or loss to the tax treatment applicable in the underlying transaction (e.g. investments in participations).

With regard to typical transactions, Portuguese generally accepted accounting principles (GAAP) establish that positive variations should be recognized by

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updating at the balance sheet date the FX spot rate on the short-term accounts payable and receivable. As regards medium- and long-term accounts payable, the principle of prudence will determine that the FX profit should only be recognized when there are reasonable indications that the favourable rate will not suffer adverse material differences in the immediate future. Otherwise, the FX profit should only be recognized when the payments are effectively made or received. In relation to negative fluctuations, the taxpayer should register the loss in the accounts at the balance sheet date.

In relation to income derived by foreign branches or subsidiaries, Portuguese law is also silent concerning FX issues. On this point, the reporters consider again that the tax rules could be clarified, namely by specifying the applicable exchange rate when the controlled foreign company (CFC) income is attributed to the shareholder. These clarifications could be complemented with further guidance on the application of FX issues on the tax treaty framework.

In conclusion, the reporters note that under the current regime FX fluctuations are taxed in a divergent manner in comparison with other income since their taxation does not depend on their realization. This effect may be further emphasized when Portugal concludes its process of reforming its corporate tax rules in order to align its principles with international accounting standards.

1. Introduction

Portuguese resident taxpayers are subject to corporate tax on their worldwide income, including income obtained through a foreign permanent establishment. Both Portuguese resident companies and non-resident entities with a permanent establishment in Portugal are subject to Portuguese corporate tax at a 25 per cent rate.[1] Non-residents are liable to corporate income tax only on Portuguese source income. Foreign taxes suffered on foreign source income are creditable against corporation tax liability on an item by item basis with no carryback or carryforward.

Under the Portuguese Constitution, corporation tax should be primarily based on the income effectively derived and not based on presumptive methods.[2] The taxable income of Portuguese companies is computed on the basis of accounting income with tax adjustments.[3] A number of tax adjustments are mandatory, namely, certain non-deductible expenses, timing of income recognition and

[1] The rate is generally increased by surtax (*derrama*) of up to 1.5 per cent on the annual taxable profits. The Budget Bill for 2009 includes a proposal to introduce a new progressive rate schedule, according to which a reduced rate of 12.5 per cent will be applicable on the first 12,500 euro of taxable profit of resident entities. The current 25 per cent basic corporate tax rate continues to apply on profits exceeding 12,500 euro.

[2] Art. 104(2) of the Portuguese Constitution.

[3] Decree-Law 410/89, of 21 November, as amended. In drawing up their accounts, companies are subject to Portuguese accounting standards as set out in the Official Plan of Accounts (*Plano Oficial de Contabilidade*) supplemented by accounting directives (Portuguese GAAP). Such standards are based on the EU accounting directives and follow to a large extent IAS/IFRS.

specific provisions or reserves for tax purposes. The term "profits" means the net income for the taxable period plus the positive and negative changes in equity (*variações patrimoniais positivas ou negativas*) during the same period which are not reflected in the taxable income defined in the profit and loss accounts. This means that the taxable base is therefore determined on the basis of the taxpayer's tax return and accounting records by deducting from taxable profits eligible prior years' losses and any tax incentives.

With the exception of financial derivatives for financial institutions, tax law does not include any significant differences on the income recognition between taxpayers engaged in different types of business. Portugal is currently in the process of reforming its corporate tax rules in order to align its principles with International Accounting Standards (IAS).

In general, the tax treatment follows the accounting treatment as to the timing of income or expenses recognition, including FX gains or losses. FX gains or losses are computed on a per event basis.

Since the adoption of the euro, income may only be computed and reported in the accounts and tax return in euro. The effect of FX fluctuations is dealt with exclusively by way of the financial accounting principles applied to compute income. Generally, all FX transactions entered into by a corporate taxpayer are, subject to certain exceptions, translated into the local currency at the exchange rate of the date the transaction occurs.[4] At the balance sheet date, monetary assets and liabilities denominated in foreign currencies should be translated into the local currency at the closing rate.

2. FX controls

Portugal no longer imposes FX controls and capital may be freely moved to third countries.[5] For statistical purposes as well as for anti-money laundering purposes, information requirements apply to transactions in foreign currency. In that regard, outbound transactions and foreign direct investment above 250,000 euro should be notified to the Bank of Portugal.[6] The same information requirements apply to real estate investments realized by Portuguese residents in foreign countries and by non-residents investing in Portugal, and to certain investments in securities and bank accounts outside Portugal. In addition, the professional trading of foreign currencies is restricted to credit institutions and

[4] The use of an average rate for a period is acceptable if the exchange rate does not fluctuate significantly during the period.

[5] For a brief description of the situation prior to the entry of Portugal into the EU in 1986, see Francisco Rodrigues Pardal, on the Portuguese branch report for the 1986 Annual Congress of the International Fiscal Association in New York and António Joaquim Carvalho, "Tratamento Fiscal dos Juros e Diferenças de Câmbio sobre a Dívida do Sector Privado em Moeda Estrangeira", CTF, no. 328/330, April–June 1986, pp. 123 *et seq*.

[6] Notices 5/93 and 1/96 of the Bank of Portugal. In relation to banks operating in Portugal the threshold is reduced to 12,500 euro (Notice 21/2001). Other entities and individuals that carry such amount or more when entering or leaving Portuguese territory are required to declare those amounts (art. 19(3) of Decree-Law 295/2003).

financial companies (specific rules apply to non-financial enterprises operating in the travelling and tourism sectors).[7]

3. Tax treatment of gains and losses attributable to currency fluctuations: general considerations

3.1. Accounting principles

Portuguese GAAP are the relevant tool for determining the tax treatment of foreign currency gains and losses. Notwithstanding this, public companies with shares listed on the stock exchange are, since 2005, also obliged to present their annual accounts in accordance with the IAS/IFRS.[8] For banks, insurance companies and other financial entities, specific accounting rules are in place.[9]

Portugal is currently in the process of reforming its corporate tax rules in order to align its principles with international accounting standards. In that regard, the Budget Bill for 2009 indicates that the government will submit to Parliament a major reform which will affect, among other things, the valuation of certain financial instruments made under IAS ("fair value") and the recognition for tax purposes of changes in the fair value of hedging instruments and the underlying hedged item. The Budget Bill also mentions that as regards cash flow hedges and hedges of net investments in foreign operations, any gains or losses generated by means of hedging are deferred until such losses or gains are recognized for tax purposes.

According to Portuguese GAAP, available funds in foreign currency are recognized in the balance sheet at the end of the financial year (generally coinciding with the calendar year).

Normally, all realized exchange differences on monetary items are recognized in the profit and loss account on an accrual basis. The FX differences are accounted either in the account 685 "financial costs or losses – negative FX differences" or in the account 785 "financial profits or gains – positive FX differences".

In relation to accounts receivable and accounts payable, operations in foreign currencies are registered at the exchange rate of the date considered for the operation, unless the exchange rate has been fixed or settled by a third entity. On the balance sheet date, the accounts receivable and payable in relation to operations in which the exchange rate has not been agreed or has not been settled are updated based on the FX rate on the closing date (last day of the financial year). The prudence principle requires that positive FX differences resulting from medium- and long-term accounts receivable and payable should not be recognized if there are reasonable expectations that the gain is reversible. These gains

7 Art. 10 of Decree-Law 295/2003 of 21 November.

8 Decree-Law 35/2005 of 17 February.

9 For further developments in relation to this issue, see Instruction 4/96 of the Bank of Portugal as amended.

are only taken into account in the year in which the total or partial payments or receivables are made.

Non-monetary assets and liabilities (stock) remain translated at the exchange rate when they were originally acquired (historical cost). This rule applies to securities and other treasury applications. In relation to FX differences derived from loans entered into for immovable assets, it is allowed to attribute the differences to the assets only while the assets are in construction.

For tax purposes, profits or gains are those derived from "any business operations or transactions, as a result of a normal or occasional trade or business … including financial income such as interest, dividends or (positive) FX differences".[10] Similarly, the tax rules recognize that financial costs such as interest and (negative) FX differences are generally recognized, provided they are "indispensable to the earning of revenues or gains liable to tax or to the maintenance of the productive source".[11]

3.2. Recognition principles

The FX elements of a transaction are treated as separate taxable objects, i.e. the taxpayer may realize a profit with a sale of a product in a foreign currency and a loss in the translation of the foreign currency into domestic currency, as a consequence of the time gap and FX differences between the registration in the accounts of the operation and its payment.

FX gains or losses are, as a rule, admitted as an ordinary gain or loss relevant to determine the taxable profit of the year. There are no specific rules or practical experience of how the tax authorities view issues such as FX gains or losses.

Nevertheless, an important distinction should be made between gains and losses, including FX gains and losses. The difference stems from a strict interpretation of the tax law by the Portuguese tax authorities, which tend to recognize profits or gains unlimitedly but do not apply the same principle to costs or losses. During tax inspections, the tax authorities frequently attempt to deny costs or losses declared by the taxpayer (and registered in the accounts) on the basis that those losses or costs are not fundamental for the maintenance of the enterprise or to obtain profits or gains subject to tax. In these cases, it is up to the tax authorities to prove why such costs or losses should not be recognized for tax purposes.

The general issue of non-recognition of costs for tax purposes is recurrently litigated with inconsistent results in Portuguese courts. The most recent cases appear to draw a trend where the judgment on whether the cost incurred is or is not fundamental for the maintenance of the enterprise or to obtain profits or gains subject to tax is for the company's management and the tax authorities should in principle not interfere in such decisions (except for cases of fraud or abuse).

The Administrative Supreme Court (the highest court as regards tax litigation) dealt with the issue of FX gains and losses in a decision of 1992. According to the facts, one enterprise had declared in its annual accounts for the financial year of

[10] Art. 20 of the Corporate Income Tax Code.
[11] Art. 23 of the Corporate Income Tax Code.

1979 a cost derived from an FX loss in contracts entered into with its parent company in the year in question. The tax authorities denied the deductibility of the loss with the argument that the company made no payment or transfer of foreign currency to the parent company in that year and, therefore, the recognition of the cost was based on an assumption. The Court decided against the tax authorities on the basis that the company had complied with accounting and tax rules, because according to the accrual principle of accountancy that is recognized for tax purposes, profits and costs should not be recognized when payments are received or made, but when sales and acquisitions are made. In addition, where there was no indication of debt forgiveness or a definitive situation of non-payment, the company proceeded according to the law. Moreover, the Court ruled that FX gains and losses should be recognized for tax purposes annually until the effective payment of the amount due.[12]

3.3. Character of FX gains and losses

Portuguese corporate tax law does not draw a specific distinction between the character of the FX gain or loss as capital or income. There is no separate tax on capital gains in Portugal and worldwide capital gains and losses are generally included in ordinary taxable income.[13] FX gain or loss should qualify as income or cost not benefiting from the specific rules applicable to capital.

3.4. Currency revaluation

According to Portuguese accounting rules, inflation and deflation is not generally taken into account. However, considering both the degree of freedom in drawing up the accounts under the GAAP and the prudence principle, inflation effects can nonetheless be taken into consideration. In this regard, in the same way as in the case of cross-border groups with consolidated accounts, in which one (or several) subsidiaries are present in a country with significant inflation (i.e. inflation rate in a three-year period exceeds 100 per cent), the FX can be translated into local currency using one of two methods: correction of inflation effects followed by conversion to domestic currency or by using the historic rate.

3.5. Transfer pricing

Portuguese transfer pricing rules follow closely the OECD transfer pricing guidelines. Accordingly, when determining the comparability between a transaction between related parties and a transaction entered into between non-related parties, due attention should be paid to the functions performed by each party taking into consideration the assets used and the risks assumed. Although Portuguese law does not substantiate what risks are referred to, it is generally understood that FX risk and potential measures taken by the enterprises to hedge that

[12] Decision of the 2nd Chamber of the Supreme Administrative Court of 8 July 1992.

[13] Capital gains may, in certain conditions, benefit from a roll-over regime in the case of reinvestment. In certain cases, only 50 per cent of capital losses are recognized for tax purposes.

risk should be considered. There are no specific rules or practical experience of how the tax authorities deal with these issues in practice.

4. Typical transactions

4.1. Purchase and sale of goods

The import and export of goods is recorded at the foreign currency exchange rate prevailing at the date the agreements are entered into between the parties. According to the Corporate Tax Code, all the entries in the accounts should be supported with dated documents and the operations should be recorded chronologically. Furthermore, delays in the execution of the accounts for a period of more than 90 days counted from the last day of the month the operations have occurred are not allowed, being subject to administrative penalties.

Sales are registered, in principle, at the date the invoice is issued. According to the Portuguese VAT Code the invoice should generally be issued no later than the fifth working day after the goods have been placed at the disposal of the buyer or when the payment is received, if it occurs before the goods are placed at the disposal of the buyer. On the other hand, the purchase of goods should be recorded when the agreement is entered into, notwithstanding that the goods and the invoice from the supplier have not yet been received or that the payment has been made.

As a consequence, FX gains or losses relevant for tax purposes will be recognized either if there is a difference between the foreign currency exchange rate on the date of the agreement and the rate when the payment is made, or when the payment has not been made, if there is a difference between the foreign currency exchange rate on the date of the agreement and the rate prevailing on the last day of the taxable period. These FX gains or losses are considered ordinary costs or profits for tax purposes, being added to the remaining relevant profits and expenses in order to determine the taxable profit subject to corporate income tax. In the case of a year-end tax loss, the latter may be carried forward for six years.

In principle, the purchase and sale of goods are recorded in the accounts in the domestic currency when the invoice is received or issued. Exceptionally, the purchase and sale of goods may be recorded before the receivable or issuance of the invoice when advance payments are made or received. This suggests that potential mismatches between the foreign currency rate when the advance payments were made or received and the rate when the invoice is received or issued may occur. Similarly, the same mismatches may occur between the exchange rates at the date of the invoice and the date payments are made or received.

On this point, we note that foreign currency exchange fluctuations are treated as financial costs or profits. These FX losses or gains do not affect the costs of inventory and such costs or profits are treated as ordinary profits or losses.

According to Portuguese GAAP, in the case of positive variations the account “financial profits and gains – positive exchange differences” should be credited

by updating the balance sheet date the FX rate on the short-term accounts payable and receivable. As regards medium- and long-term accounts payable, the principle of prudence determines that the FX profit should only be recognized when there are reasonable indications that the positive FX rate will not suffer adverse material differences in the immediate future. Otherwise, the FX profit should only be recognized when the payments are effectively made or received. The same principles apply in relation to positive FX differences in day-to-day trading, when there is a difference between the exchange rate at the invoice date and the exchange rate when the payment is made or received.

As regards negative fluctuations, the taxpayer should register the loss on the account "financial costs and losses – negative exchange differences". The specific rule concerning medium- and long-term payables is not applicable in the case of negative variations and the loss should be registered at year-end.

4.2. Measuring the cost of depreciable property

The acquisition cost of property is determined when property is acquired even if actual payment of the property is deferred in time. The cost of depreciable fixed assets is booked using the historic rate. In computing gains or losses on the sale of depreciable property currency differences are not added to the acquisition cost (i.e. historical price minus depreciation and amortization allowances recognized for tax purposes).

4.3. Measuring the cost of real estate and investment in securities

The tax treatment of purchasing real estate with foreign currency, as well as investments in securities, is identical to the tax treatment of the purchase and sale of goods outlined in section 4.1 above. As a result, the character of a foreign currency gain or loss is separate from the gain or loss derived from the underlying transaction as the latter are qualified for corporate income tax purposes as capital gains or losses. Capital gains or losses benefit from special computation rules and rollover relief, which may reduce the taxable gain by half. The tax deductibility of capital losses on the sale of shares or other corporate rights is also limited.

4.4. Intangible property

The tax treatment of purchasing intellectual property with foreign currency follows in general terms the tax treatment of the purchase and sale of goods outlined in section 4.1 above. As a result, the character of a foreign currency gain or loss is separate from the gain or loss derived from the transaction in intangible property as the latter is qualified for corporate income tax purposes as capital gains or losses if the intangible property is booked in the accounts as intangible property (and not as inventory).

There is a special rule allowing for the depreciation of negative FX differences related to intangible property.[14] As a general rule, intangible assets are

[14] Art. 17 of Decree 2/90 of 12 January as amended, implementing the tax amortization and depreciation regime.

depreciated on the basis of useful life. According to the rule in question, negative FX differences related to intangible property registered prior to its use or depreciation may be taken into account as costs of the intangible property. In that case, such costs should be apportioned in equal parts for a period of at least three years.[15]

4.5. Financing (borrowing and lending)

Borrowing and loans in foreign currency are valued in the taxpayer's domestic currency at the FX rate in effect when the financing is put in place. At the balance sheet date, third party payables and receivables are updated at the closing rate, on the same terms and conditions outlined in section 4.1 above.

There are no specific rules to apportion the FX rate differences if a loan is made at a discount or premium and there are fluctuations in the FX rates. In the reporters' opinion, the parties should recognize the taxable profit or loss related to the premium/discount and separately recognize any FX gain or loss between the amount received or paid and the amount to be repaid at the termination of the financial agreement.

Interest on loans where the applicable FX rate was set in the agreement may generate foreign currency gains or losses, which should be accounted separately from the interest expense. If the FX rate is not determined, when interest is paid in a foreign currency that same interest should be translated into domestic currency and considered as an expense for tax purposes.

In the case of repayment of the principal, if there is an FX rate difference between the date the loan was entered into and the repayment date, the difference should be recognized as an FX gain or loss relevant for tax purposes.

For corporate tax purposes, changes in the terms of a debt obligation do not necessarily give rise to a new obligation and therefore FX gains or losses do not need to be recognized.

4.6. Hedging

Portuguese corporate tax rules recognize the concept of hedging as regards derivative financial instruments. This section will focus on the tax treatment of derivative instruments such as swaps, options and forwards entered into to avoid gains or losses attributable to FX differences.[16]

On this point, the rules draw a distinction between transactions entered into on the regulated market and those undertaken outside the markets and between transactions made for hedging purposes and transactions made for speculative or trading purposes. Unless an exception applies, derivative financial instruments entered on the stock exchange have to be "marked to market", i.e. deemed sold at their fair market value, at each taxable year-end.[17]

[15] This three-year apportionment rule equally applies to expenses with the issuing of bonds, financial charges related to the acquisition or production of intangible property registered prior to its use or depreciation and expenses related to advertising campaigns.

[16] In relation to the accounting treatment of these operations, see *Directriz Contabilística* no. 17, IAS 32 and specifically for financial institutions, see Instruction 4/96 of the Bank of Portugal as amended.

[17] Art. 78(1) of the Corporate Tax Code.

The principal exception to mark-to-market treatment is the hedging exception, which applies if: (a) the hedging contributes to eliminate or attenuate a real currency fluctuation risk derived from another operation, including future risks of operations made in previous years that are still outstanding or from a future operation; (b) there is a high degree of probability of the currency risk; and (c) there is an economic link between hedging the underlying operation so as to potentially neutralize the losses of the underlying operation with the gains of the hedging transaction.

In order to be qualified as hedging, the hedge amount should not exceed the amount involved in the underlying transaction. For tax purposes, the operations made to hedge risks from third parties, operations entered into by investment funds, venture capital funds, pension funds, insurance companies, banks and other financial institutions as well as transactions not properly identified as a hedge are also not recognized as hedging.

As regards the tax treatment of hedging transactions, the rules allow the deferral of non-realized gains to the following two years in case of losses not yet realized in the underlying operation.[18] In the case of hedging losses, they are only recognized for tax purposes up to the limit of the gains not yet taxed in the symmetrical position. Special rules are in place for the assignment or cancellation of swaps and forward contracts.[19]

Finally, a specific anti-abuse rule applies to financial derivatives, according to which if the substance of a transaction or series of transactions differs from its form, the tax authorities may recharacterize the time, source and nature of the payments and receipts, gains and losses resulting from the transaction. According to the reporters' knowledge, the tax authorities have never used this substance-over-form provision in practice.

Neither Portuguese accounting rules nor Portuguese tax rules address the issue of natural hedge. In this event, the reporters consider that the enterprises should follow the guidance of IAS 21.

5. Foreign currency issues related to foreign branches or permanent establishments

5.1. Portuguese branch of a foreign company

The profit attributed to a Portuguese branch or permanent establishment of a non-resident company is assessed for corporate income tax according to the rules applicable to resident companies. The general rule for the attribution of profits to a permanent establishment provides that such permanent establishment should

[18] If the underlying operation is not closed, the tax that was not paid because of the deferral should be paid in that year plus compensatory interest.

[19] Basically, the potential loss incurred is deductible in the year the derivative is assigned/cancelled but the amount deductible cannot exceed the lower of: (a) the settlement payments or termination payments made in accordance with the original contract; or (b) the market value of operations bearing the same characteristics of the operations assigned or cancelled and namely with a term equal to the remaining term of the operation assigned or cancelled.

maintain a separate balance sheet as well as separate profit and loss accounts for its operations (separate accounting method). Thus, the accounting records form the starting point for determining the taxable profits of local branches or permanent establishments. The issues outlined in section 4 are therefore applicable.

5.2. Portuguese company with a foreign branch

Portuguese resident companies are liable to Portuguese tax on their worldwide income. As a result, the profits or losses of foreign branches or permanent establishments must be included in the company's tax computation. The general method for elimination of double taxation applicable under the Portuguese tax treaties is the credit method and therefore the domestic or foreign source of the exchange gain or loss is not decisive.

The corporate tax rules do not include any specific provisions concerning the allocation of income to a branch. Nevertheless, it is understood that each transaction of the branch should be individually recorded in the head office accounts. If the branch accounts are kept in a different currency, the profits or losses should be translated into local currency by applying, with the necessary adjustments, the rules set out in section 4 above.

A recent decision of the Administrative Supreme Court specifically dealt with FX losses and tax reserves for the depreciation of financial assets.[20] Under the corporate tax rules, certain mandatory reserves are recognized for finance and insurance companies under the supervision of the Portuguese Central Bank and Insurance supervisory body.[21] The annual amount of provisions for credit risk and country risk of companies engaged in the banking and insurance businesses may not exceed the maximum amounts established by the respective supervisory bodies.

The case dealt with a Portuguese bank with a branch in Mozambique, which due to the depreciation of the capital attributed recognized in the accounts of the head office a tax provision to cover risks of FX fluctuations.[22] The tax authorities denied the recognition of the cost related to the provision for the depreciation of financial assets because this provision was not expressly mentioned in the Notice of the Bank of Portugal referred to in the law. The Notice of the Bank of Portugal only mentioned that banks were obliged to set up provisions for capital losses derived from shares and other securities as well as for financial assets. The Court agreed with the taxpayer's arguments and ruled that capital attributed to the branch is a financial asset. Accordingly, the provision set up for depreciation of capital attributed to the branch due to FX fluctuation should be considered as a cost relevant for tax purposes.

As regards the attribution of income of foreign permanent establishments, Portuguese tax treaties follow article 7 of the OECD model convention. It is difficult to anticipate the impact and the direction of the practice of the tax authorities as a result of the recent OECD developments. Taking into account the

[20] Decision of the Supreme Administrative Court issued on 28 May 2008.

[21] The annual amount of provisions for credit risk and country risk of companies engaged in the banking and insurance businesses may not exceed the maximum amounts established by the respective supervisory bodies.

[22] Currently art. 35-A of the Corporate Tax Code.

number of observations included by Portugal on the last 2008 amendments to the commentaries to the OECD model convention, it is the reporters' opinion that taxpayers may expect some difficulties in the future on the application of the functionally separate enterprise principle.

6. Foreign currency issues relating to foreign subsidiaries

6.1. Actual distribution of foreign subsidiary earnings

Unless CFC rules apply, profits of foreign subsidiaries are only liable to Portuguese tax when they are distributed to a Portuguese shareholder or when the subsidiary is liquidated. Dividends paid by domestic or EU resident subsidiaries generally benefit from a domestic participation exemption, provided the parent holds 10 per cent of the distributing company's capital or any capital percentage valued at 20 million euro or more for an uninterrupted period of at least a year. Other dividends are fully taxable as part of the profits of the company.[23]

From a Portuguese accounting perspective, the income derived from abroad should be normally accounted in the accounts of the recipient. This income must be recorded on a gross basis and any withholding tax levied should be accounted for separately as a related cost. The exchange rate used to determine the value of the dividend is that applicable on the date the dividend is paid.

Most Portuguese tax treaties provide that double taxation should be eliminated in accordance with the domestic tax credit mechanism.[24] Accordingly, a tax credit is given when the taxable income of a Portuguese taxpayer includes (gross) income that was subject to taxation abroad. The tax credit will correspond to the lower of the following amounts: (a) an amount equal to the income tax paid in the foreign country; (b) Portuguese tax that is proportionally attributable to the foreign source income, after the deduction of all expenses and losses directly or indirectly incurred in obtaining such income.

The Portuguese Corporate Tax Code does not include any specific rule providing the date at which the withholding tax should be translated into local currency. Nonetheless, it may be argued that withholding taxes should be translated using the rate prevailing when such taxes are actually paid. Once again, this may give rise to FX gains or losses at the time when the income is credited.

6.2. Taxation of CFC income

Under Portuguese CFC legislation, an individual or company resident in Portugal, holding directly or indirectly shares in a qualifying CFC, is subject to tax on the profits realized by that CFC.

[23] Since 2007, the participation exemption regime has extended to qualifying dividends from subsidiaries resident in states with Portuguese as their official language (i.e. Angola, Cape Verde, Guinea Bissau, Mozambique, East Timor and São Tomé and Príncipe).

[24] Art. 85 of the Corporate Tax Code.

For Portuguese tax purposes, a CFC is an entity held by Portuguese residents (25 per cent shareholding or 10 per cent where more than 50 per cent of the capital is held by Portuguese residents) which is located in a low-tax jurisdiction (i.e. blacklisted territories and jurisdictions where no tax is paid or where the effective foreign tax rate is equal to or less than 60 per cent of the Portuguese corporate tax rate). The application of the CFC rules can nevertheless be avoided provided: (a) at least 75 per cent of the CFC profits arise from local agricultural or manufacturing activities, or from commercial transactions mainly with the local market or not involving Portuguese residents; and (b) the CFC's main activity is other than one of the listed activities (e.g. banking, certain types of insurance, holding or transfer of corporate rights or other securities).

The profits resulting from the activities of a CFC are, in principle, taxable in the hands of its resident members and attributed in the proportion of the shareholdings. Under the Portuguese rules and distinctly from other CFC regimes, the income is computed by applying the tax rules applicable in the CFC residence state (i.e. host state). This suggests that if the CFC has no income according to the local rules, no income can be attributed to Portuguese residents. No administrative or judicial guidance is available on the approach of the tax authorities in determining the income to be attributed under the CFC rules. Lastly, any final taxes paid abroad are creditable against the Portuguese taxes levied on the CFC income. Dividends subsequently distributed by the foreign entity are taxable only up to the amount exceeding the income that has already been taxed in the hands of the Portuguese resident under the CFC regime.

The law is silent as regards the application of any particular exchange rate when the CFC income is attributed to the shareholder. It may be argued that the principles similar to those applying to foreign branches of Portuguese companies should apply. In that case, the CFC income attribution would be determined taking into account the exchange rate applicable at the financial year-end. This exchange rate may well vary from the exchange rate applicable at the time the dividend is actually distributed to the shareholder. Applying the principles set out above, any difference in rates will give rise to an FX gain or loss recognized for tax purposes. There are no adjustments in place to deal with changes in value of foreign currency (and related foreign tax) between the time when income is attributed and distributed.

7. Foreign currency gains and losses and tax treaties

The tax treaties concluded by Portugal are silent on the question of foreign currency issues and there is virtually no literature on the topic of the international issues of currency gains or losses. We envisage that problems may nonetheless arise in the framework of related party transactions. For example, timing issues could arise on the non-recognition of currency losses on loans made by Portuguese resident companies when the other country taxes the currency gain. In addition, withholding taxes on passive income may be refunded under a tax treaty at a date considerably later than that when the income was due to be paid, therefore originating an FX currency gain or loss.