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Portugal: 2004 Year in Review

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Portugal in 2004 was marked by political upheaval. During the summer, then-Prime Minister José Manuel Durão Barroso resigned to become the first Portuguese president of the European Commission. New Prime Minister Pedro Santana Lopes was appointed midterm despite internal debate and hesitation from President Jorge Sampaio. At the end of November, Sampaio dissolved the Portuguese Parliament even though the government had a parliamentary majority, a situation that is unique in recent constitutional history.

The leitmotif of the current political crisis has been economic and financial instability — problems regarding public expenses, the public deficit, and even public debt on the one hand, and discussions about the fairness of the tax regime and the best way to combat tax evasion on the other hand. Other political incidents also helped Sampaio justify his decisions.

Given the political climate, only a few important legal provisions were changed during 2004. One of the most significant changes was the reform of real estate taxation. Although the reform made mostly minor changes to the previous provisions, it is expected to considerably change the behavior of economic agents operating in the real estate market. Another change that could have a major effect was the publication of binding rulings by Portuguese tax authorities, which — together with new and more efficient tax courts — might provide the boost that the Portuguese tax justice system needed.

Following are highlights of some of the measures that could affect foreign investors in 2005.

Real Estate Taxation

The main goals of the real estate tax reform were to simplify legal procedures, combat tax evasion, and broaden the tax base, aligning new real estate values with realistic market values. After years of discussion, the property transfer tax (SISA) and municipal property tax (*Contribuição Autárquica*) were finally replaced with two new taxes on January 1, 2004.

For purposes of the new municipal property tax, older real estate is revalued according to monetary devaluation coefficients, while new urban real estate is valued according to objective rules such as:

- the construction price of the building;
- the interior square footage;
- the location (for top locations, a factor of 3 points is applicable);
- the quality and amenities (such as a garage, central heating system, swimming pool, and other leisure facilities); and
- the date of the construction.

As an result of the new rules, the Portuguese Executive in 2004 also approved data for determining the tax value of urban property, and base-cost constant values for the Portuguese territory.

Foreign Property Owners

Since January 2004 foreign property owners have had more reason to be concerned, as Portuguese authorities have fired a tax bombshell at offshore companies that own real estate in Portugal. New legislation provides that nonresident companies incorporated in low-tax jurisdictions (as identified by a Finance Ministry blacklist) that own real estate in Portugal are subject to a new rate of 5 percent (formerly 2 percent) on the value of the real estate.

In principle, at the 5 percent rate, in 20 years the owner will have paid the entire value of the property in taxes.

Gift and Inheritance Tax

January 2004 also brought the repeal of the gift and inheritance tax (ISD). As a result, free transfers are now subject to stamp duty at a rate of 10 percent, with the exception of transfers to spouses, descendants, and ascendants, which are tax-exempt.

EU Arbitration

Portugal also finally ratified the Prolongation Protocol to the EU Arbitration Convention. Presidential Decree 27/2004, implementing the May 25, 1999, protocol extending the EU Arbitration Convention of July 23, 1990, was published after a parliamentary resolution. Portugal was the last EU member state to ratify the protocol and, consequently, the Arbitration Convention will fully reenter into force after a transition period that lasted more than four years.

New Tax Forms

After a discussion in 2003 that led to the assignment of a tax identification number to every nonresident that obtains Portuguese-source income subject to withholding tax, the Portuguese Executive issued a new tax form for payments to nonresidents (Model Form 30). The new form must be filed via Portuguese tax authorities' official Web site (www.e-financas.gov.pt) and must indicate the amount of income paid to a nonresident and the withholding tax due on that payment.

The form must be filed by July 31 each year, although an exceptional regime established for 2004 allowed for filing until the end of October. Finally, a new regulation establishes that all forms claiming a waiver of withholding tax or a tax reduction under a double tax treaty must be set aside for a 10-year period.

Tax Justice

Following the direction of the 2003-2004 reform and aiming for a faster resolution of tax disputes, new tax courts were established throughout Portugal, and the number of court staff was increased significantly. At the same time, the tax authorities' Web site now includes several binding rulings that clarify some significant matters of tax law, including thin capitalization, transfer pricing, and tax benefits.

Tax Treaties

In 2004 Portugal ratified tax treaties with Slovenia, Slovakia, and Estonia, but none of those treaties has entered into force. Tax treaties with Latvia and Lithuania entered into force on January 1, 2004.

Budget Proposal for 2005

The Portuguese Executive presented its 2005 budget bill to the parliament in October 2004. The budget bill, which focuses on reducing the public deficit and fighting tax evasion, received criticism for its lack of strategy and drive to stimulate the economy. It seems that the main — almost exclusive — concern was to reduce tax incentives and rein in taxpayers' rights and guaranties. Proposed changes that concern both resident and nonresident taxpayers include, among other things:

- the denial of tax benefits to resident or established companies that would cause their annual tax liability to fall below 60 percent of the amount that would otherwise be due;
- a tax cut for income derived by nonresidents from real estate, to 15 percent from the current 25 percent, and for business income from a permanent establishment of a nonresident individual, to 25 percent from the current 30 percent; and
- a tax amnesty that would allow resident individuals that hold investments in securities and cash kept in offshore jurisdictions to repatriate those assets under a one-time taxation at the rate of 5 percent of the value of the asset.

The result of the general election scheduled for February or March 2005 will be decisive. The budget bill, which had been scheduled for a vote on December 2, 2004, probably will not survive as originally drafted, because it will be difficult for the coalition in power to gain popular support. However, some final amendments to the budget propose lower taxation at low-income levels and an increase in public wages. ◆

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