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Portugal's Parliament Approves 2003 Budget Bill

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Portugal's Parliament on 14 November finally approved the nation's budget bill proposal for 2003. The measure's goals are to reduce the public deficit, propose ways to fight tax evasion, and introduce measures to increase Portugal's economic competitiveness. The bill rules out the adoption of immediate tax reforms, notably restructuring of the so-called obsolete taxes, such as the transfer tax on building sales, municipal real estate tax levied on a building's value, inheritance and gift taxes, and vehicle taxes.

Characterized by observers as relatively "modest but realist," opposition to the bill has come mostly from left-wing opposition parties who would like more social spending. The government, which was only formed in March 2002, inherited a complex task: to reduce the public deficit from 4.10 percent in 2001 (clearly above the 3 percent ceiling that the EU Stability and Growth Pact rules establish) to zero percent (the goal originally set by the 15 EU member states for 2004, now for 2006). The government is trying hard to accommodate public accounts within the EU public deficit ceiling of 3 percent, and the goal is to achieve 2.8 percent in 2002. For 2003, the government intends to reduce the public deficit to 2.4 percent of GDP.

EU constraints and internal social stability were certainly two important factors that prevented Portugal from taking bolder steps. Public expenditures were reduced significantly, primarily from a decrease in capital expenditures, rather than spending. Tax revenues are expected to grow in 2003, mostly from indirect taxes; standard rates for VAT (which was responsible for 83 percent of the increase in indirect tax revenues) rose from 17 percent to 19 percent last June. Corporate income tax revenues are expected to drop by 2 percent this year, reflecting companies' lackluster economic performance and a corporate tax rate cut from 32 percent to 30 percent in 2002.

Even so, Portugal's 2003 budget includes some changes that, when considered with other tax measures adopted during the last months, may represent new trends and opportunities. This article focuses on those aspects, particularly incentives for nonresidents and resident corporate entities and provisions designed to combat tax evasion.

Tax Incentives

Several amendments to current rules and the expansion of an existing tax regime favorable to reorganizations demonstrate the government's intention to promote investment and present new opportunities to taxpayers.

First, companies entering into reorganizations may continue to present a formal request to the minister of finance to obtain specific exemptions, such as transfer tax on the transfer of a building, legal fees connected with notaries and registration services, and stamp duties relating to those operations. (The possibility of obtaining the latter exemption is mentioned in internal decisions of the tax services, though not expressly mentioned in Decree 404/90.) Those exemptions are especially attractive if one can aggregate them with tax-neutral operations or others where tax losses may offset profits of other companies.

Second, Portugal's government has received an express authorization to enact a special tax regime

Table 1.
Forecasts of Tax Revenues (Millions of €s)

	Budget Bill for 2002	Proposal for 2003	Percent Change
Individual Income Tax	7,413.9	7,731.2	4.3
Corporate Income Tax	4,203.7	4,118.4	-2
Others	99.5	101	1.5
Total of Direct Taxes	11,717.1	11,950.6	2
Petrol Tax	2,700	2,916	8
VAT	9,813.5	10,652.8	8.6
Vehicle Tax	1,211	1,229.2	1.5
IT	1,117.3	1,175.3	5.2
Stamp Duties	1,192.3	1,210.2	1.5
Others	286.4	327.8	14.5
Total of Indirect Taxes	16,320.5	17,511.3	7.3
Grand Total	28,037.6	29,461.9	5.1

for investments made abroad by resident companies. A tax credit of an amount up to 20 percent of the corporate income tax can be granted, provided the company agrees to make a specific investment in tangible assets (excluding urban property or other assets not granting the right to deduct VAT) and R&D in the two years following the date on which the deduction occurs. The government will issue new regulations that will indicate the values of investment and the sectors of activity covered by that provision. If a company fails to meet its obligations, the tax that was spared will be subject to compensatory interest (currently 7 percent) plus 5 percent. That tax incentive cannot be used or completed by other legal or contractual tax incentives.

Capital Gains Tax Cuts

The government tried to complement the Budget Bill proposal with an accompanying legal act (Decree 228/2002 of October 31) that amended the individual income tax code. As previously noted, the revitalization of the Lisbon Stock Exchange has been cited as an important reason to reinstate capital gains tax exemptions or reductions. Under the current regime, capital gains obtained with the sale of securities by nonresident individuals and companies without a permanent establishment (PE) in Portugal to whom those could be attributed are tax-exempt, as long as: the seller is not a resident of a tax haven; the seller is not owned, directly or indirectly, by a resident; and at least 50 percent of the Portuguese company's assets do not consist of Portuguese real estate.

Regardless of their place of residence, individuals who realize gains with the transfer of shares held for more than 12 months are tax-exempt on that disposal from 1 January 2003. Capital gains realized by individuals with the sale of bonds and other debt securities are also exempt from tax. Speculative gains realized by individuals with shares held for less than 12 months are subject to a tax rate of 10 percent.

Capital gains realized by resident corporate entities are fully taxable, except: if one may exclude 50 percent of the gain, provided the total consideration received is reinvested within a four-year period beginning in the year preceding the disposal; or if a specific exemption applies, as is the case for the gains obtained by holding companies.

Holding Companies

Portuguese holding companies can benefit from a total (100 percent) dividend participation exemption and from a total capital gains exemption on the gains obtained with the sale of shares or quotas of other companies.

Those exemptions are not subject to a minimum holding in votes or in capital. The minimum holding period is just one year. The drawbacks are that the holding companies cannot benefit from a capital loss deduction, which could offset other types of income, such as interest and fees for services rendered to subsidiaries. From now on they also cannot deduct financial expenses, such as interest, provided those loans were contracted to acquire equity.

Fighting Tax Evasion

The reduction of the Portuguese public deficit and the tax burden on Portuguese taxpayers is directly linked with the performance of the Tax Authorities in the fight against tax evasion. Therefore, the bill introduces several amendments to the tax codes aimed at ensuring an effective taxation, notably of capital income.

Related Parties

The bill introduces an amendment to the deductibility- of-losses rule of the corporate income tax code (CIRC), stating that capital losses realized with the sale of securities between related parties or to entities resident in low-tax jurisdictions are nondeductible.

Related parties are deeming to exist whenever a special relationship exists between two entities in situations in which one may exercise, directly or indirectly, a significant influence in the management decisions of the other.

Therefore, taxpayers should conclude and register a loss on the sale of equity if a group restructuring is envisaged to be able to deduct any capital losses on such a sale. Otherwise, those reorganizations should follow book values and the domestic and EU rules regarding those transactions, to postpone any tax impact.

Use of Derivatives

Derivative financial instruments have been used for tax planning purposes, mainly for generating tax- deductible losses. Therefore, a general legislative authorization was introduced in the budget for the amendment of the existing tax rules regarding derivative financial instruments.

Notwithstanding, the government proposes the introduction of a specific limitation on the use of swaps by credit institutions and financial companies resident in Madeira's International Business Center, under which swap transactions are not permitted unless the swaps are aimed at hedging active or passive positions of the credit institutions resident in the Madeira IBC itself.

The taxation of Madeira branches of Portuguese credit institutions and financial companies has been a very controversial issue, namely regarding the definition of transactions that those branches are allowed to execute in order to prevent the allocation of taxable income to virtually tax-exempt entities. Portugal's government has already approved Decree 555/2002, dated 4 June, limiting the allocation of profits to Madeira branches to 20 percent of the global profits of those institutions.

The CIRC, however, already has a special rule regarding the deductibility of losses generated by derivative financial instruments, under which the deductibility of those losses regarding offsetting positions is limited to losses that surpass the imputed gains not yet taxed on those same positions.

A specific antiavoidance rule regarding swap transactions disallows the deductibility of losses arising from the payment of compensation other than the one defined originally in the swap contract, whereas it is the taxpayer that bears burden of proof to confirm the fulfillment of the admissibility of the swaps losses under such a rule.

New Formal Obligations

Following the amendments to the individual income tax code (CIRS) introduced by Law 109-B/2001, the 2003 budget law further develops the information and tax withholding obligations imposed on financial intermediaries and registration and custodial entities.

The new legislation follows the trend of shifting the burden of tax obligations on capital income to market makers by imposing the withholding of the tax due on securities distributions and capital gains, namely for taxation of nonresidents' income, as a way to fight tax evasion in that area.

Furthermore, the Portuguese tax authorities are aware of the need to identify the beneficial owner of the payments of dividends or interest from securities to curb tax evasion structures. Hence, disclosure of information is a major issue, and applications for treaty benefits, as well as tax benefits and exemptions, require the identification of the beneficial owner.

Failure to identify the beneficial owners may easily arise from channeling investments through omnibus accounts, a common practice in capital markets. That has led the government to seek and obtain an authorization to enact specific antiavoidance legislation to halt bond washing as well as dividend stripping cross-border transactions.

The proposed new article 88 of the CIRC imposes, on registration and depositary entities, the obligation to withhold the tax due on the payments of dividends or interest from securities issued by Portuguese entities and legally subject to registration or deposit under the Portuguese Securities Code. Therefore, in the future those entities will be responsible for collecting and delivering the withholdings to the tax authorities, and failure to withhold such a tax will create a direct tax liability for themselves.

Nonresident registration and depositary entities hence will be required under the proposed new article 125 of the CIRS to appoint a fiscal representative for the fulfillment of their tax obligations.

In addition to those new obligations, the Portuguese government has decided not to postpone the application of the capital gains "current account" system, under which financial intermediaries are obliged to withhold tax on capital gains, obtained with the sale of securities, at a rate of 10 percent.

Financial intermediaries will be obliged to maintain for each taxpayer a "current account," whereby the respective capital gains and losses are credited and debited, by applying a 10 percent rate on the gains and losses. If a capital gain is realized, the financial intermediary must withhold tax at a rate of 10 percent. Capital losses will determine the restitution of the capital gains tax withheld, if any has been previously withheld.

Although there are doubts regarding the feasibility of the implementation of such a tax withholding system — namely for nonresidents who invest through omnibus accounts of international banks or clearing houses — it appears that such a rule will be effective as of 1 January 2003.

Finally, the budget for 2003 authorizes the government to enact legislation to exempt nonresidents from capital gains tax on bonds issued by Portuguese resident corporations. Nonresident financial institutions should thoroughly examine the new Portuguese rules on the taxation of capital markets, because those obligations may give rise to a direct tax liability.

Liaison Between Tax Authorities

The tax authorities have been experiencing many difficulties fighting tax evasion, which is frequently linked with other criminal activities. However, the confidentiality obligation regarding tax information imposed on the tax authorities has prevented an efficient cooperation with the police force, notably with the white-collar- crime police force.

Therefore, the 2003 budget bill introduces a legislative authorization for the enactment of measures to grant to the police force greater access to the tax databases through amendments to the tax confidentiality rules.

Conclusions

The 2003 budget bill represents an understated turning point: a return to first principles of financial "housekeeping." Rather than introducing flamboyant measures, the government is attempting to meet EU Stability and Growth Pact goals while creating a solid platform for future economic growth. It remains to be seen whether those measures will suffice to put Portugal's financial "house" in order. ◆

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