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Tax Reform Negatively Impacts Nonresident Entities Operating in Portugal

by Francisco de Sousa da Camara and Phillippa Cannon

Portugal has introduced a comprehensive tax reform package with effect from 1 January 2001. According to the government, this reform represents a significant step toward its declared goal of combatting tax evasion and promoting tax equity. Cabinet Resolution No. 119/97 (amended in 1998) sets out the Socialist government's agenda. How far these measures will go toward stemming the flow of inward investment into Portugal, while simultaneously encouraging the "flight" of capital from Portugal, is a moot concern.

Amendments were made to the existing Individual and Corporate Income Tax Codes (IRS and IRC), the Tax Incentives Statute (EBF), the General Tax Law (LGT), and the Procedural Tax Code (CPPT). Additionally, several specific pieces of legislation were adopted.

The reform package has important implications for nonresidents. At a time of change and inevitable uncertainty, this article seeks to shed light on the principal factors of importance to individual and corporate investors.

I. Capital Gains on Securities

This topic can usefully be broken down into four main components.

First, the tax exemption previously granted to individuals who held shares for a period of more than 12 months has been abolished. Moreover, the final tax rate applicable to capital gains obtained by individuals on the transfer of securities owned for less than 12 months has been increased from 10 to 20 percent. This tax is now only applicable to nonresidents.

Capital gains obtained by individuals on the transfer of securities will now be subject to tax on a sliding scale. The same rules apply to capital losses, with the necessary adjustments. In summary, gains or losses will be considered for tax purposes as follows:

- 75 percent of the value when the holding period is less than 12 months;
- 60 percent of the value when the holding period is between 12 and 24 months;
- 40 percent of the value when the holding period is between 24 and 60 months; or
- 30 percent when the holding period is 60 months or more.

The gains will be aggregated to other net income and will be subject to tax in accordance with a progressive scale (over PTE 10 million is 40 percent).

Second, capital gains obtained by corporate entities on the transfer of tangible assets (including gains realized on indemnities for the loss of tangible assets) become taxable immediately, unless the total amount raised from the transfer is reinvested within the same tax year, the preceding year, or the next two years following the transfer. In the case of reinvestment, the capital gain is taxed over a period of five years (at a rate of 20 percent per year), beginning in the tax year in which the gain was realized.

Third, capital gains obtained by holding companies (SGPSs) on the transfer of securities follow the same pattern of treatment outlined in the above paragraph. Until now, those capital gains could be rolled over indefinitely. To lessen the impact of this

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dramatic change, transitional rules have been adopted that defer the taxation of capital gains obtained by the sale of securities owned prior to 1 January 2001.

Finally, the tax regime relating to the taxation of capital gains obtained with the transfer of securities by nonresident corporate entities without a Portuguese PE to whom such gain could be attributable has become more stringent. To qualify for an exemption from corporate income tax, the following four conditions must be met:

- no more than 25 percent of the nonresident entity should be owned, directly or indirectly, by resident entities;
- the nonresident entity should not have as its place of residence a state or jurisdiction identified in a black list of tax havens, to be published by the Ministry of Finance;
- no more than a qualified participation in the resident entity may be sold (as of 26 March, it is still not clear which percentage equates to a qualified participation); and
- the main assets of the resident company cannot be made up of real estate located in Portuguese territory.

II. Holding Companies

In general, the new measures on capital gains are bad news for holding companies (SGPSs — companies that are exclusively incorporated to derive income from nondirect economic activity). Consequently, there has been considerable media speculation regarding the likely response from holding companies.

Some argue that an exchange of share operations will take place within the EU, so as to benefit from the merger directive rules and the more favorable regimes for capital gains existing in other member states. Others argue that the simple sale and purchase agreements have already been put in place. There are also those who claim that the place of effective management of many holding companies will move from Portugal, to be taxed (or not taxed) as residents of other countries.

Meanwhile, the government may take further steps to prevent avoidance, either through an existing general antiavoidance rule or by specific measures.

On a more positive note, the government has tried to encourage long-term investments by creating rules to abolish completely economic double taxation. Previously, only 95 percent of dividends received by holding companies were exempt from tax.

In conclusion, Portugual could now be seen as a more interesting choice for long-term investment. Economic double taxation has been totally abolished and EU companies can benefit from the parent-subsidiary directive. Conversely, and more importantly, the taxation of capital gains has diminished Portugal's attraction for the majority of holding companies — whose businesses revolve around the buying and selling of securities.

III. Dividends

Profits and dividends paid by Portuguese subsidiaries to parent companies in EU member states will now be subject to a provisional withholding tax (25 percent) for the first two years following the acquisition of at least a 25 percent holding in the Portuguese subsidiary. This represents an attempt, of arguable legality, to maintain revenue despite the ECJ ruling in the *Denkavit* case. The option of not imposing any provisional withholding tax on dividends, as in the United Kingdom, was rejected.

If this minimum holding is maintained after this two-year period, and provided the requirements outlined in article 2 of the parent-subsidiary directive are met, a refund can be requested.

IV. Stock Options

A more sophisticated system of fringe benefits taxation has been introduced. Previously, a broad definition of employer-granted benefits existed. Inconsistencies arose from practical obstacles and there was a lack of legal discipline in computing the level of benefits.

The new rules cover the definition of income, qualification as an employer, the timing of the moment when a liability arises, and the computation of capital gains relating to stock options.

Income from employment is deemed to exist in a broad number of situations. These encompass gains from subscription rights for the benefit of employees or members of corporate bodies, gains resulting from the sale of options or subscription rights, gains resulting from the waiver of the exercise of the option to the benefit of the employer, and gains arising from the repurchase by the employer of the shares or rights.

The employer is defined as "any entity that pays compensation qualified as employment income." No withholding at source is applicable. Capital gains obtained on the sale of the shares must be aggregated with other income and may be taxed either as employment income or capital gains, depending on the identity of the purchaser.

The reform increases the obligation to report benefits. An obligation is created for Portuguese employers, whose employees have been provided with shares in nonresident companies, to report the "existence of such situation" to the tax authorities in an official form. If the Portuguese company bears

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the costs of the plan related to the foreign entity or the respective benefit, then a number of mandatory statements must be made to the employee and the tax authorities.

V. Transfer Pricing

The primary rule on transfer pricing — article 57 of the IRC — was completely amended and will become effective 1 January 2002. The current regime will remain in operation until that time.

Although the fact that tax authorities may adjust prices between related entities (entities with a "special relationship") is not new, several additional powers will become available in 2002. A "special relationship" will be considered to exist when one may exercise, directly or indirectly, a significant influence on the management decisions of the other entity. This is considered to have happened, for instance, when an entity holds a participation, directly or indirectly, of not less than 10 percent in another entity or both entities are related between them.

The type of transactions that may attract a tax adjustment are more broadly defined and include transactions relating to goods, rights, or services.

Reference is now made to the OECD's methodologies, thereby placing more emphasis on comparable and traditional transactional methods. Other methods can be followed, however, provided that traditional methods are shown not to be more reliable in calculating the pricing that would occur between independent entities.

The definition of a "special relationship" between entities has been substantially extended and sharpened. It now goes much further than the OECD Model Convention's definition of "associated enterprises."

Documentation requirements in relation to the policy adopted for transfer pricing have now been introduced. These include the contracts or legal agreements that exist with the entity with which there is a special relationship.

Taxpayers must declare the existence or otherwise of any special relationships in their tax returns each year, and the details of those relationships should be released to the tax authorities.

The regulation of the overall regime will be clarified by a rule yet to be issued by the Ministry of Finance.

Although approximation to the OECD's guidelines on transfer pricing is welcome, some of the requirements seem to be unnecessarily onerous and will represent an additional burden for taxpayers.

VI. Antiavoidance Provisions Reinforced

A. Introduction

In 1999, corporate income tax receipts accounted for just 16.25 percent of total tax receipts in Portugal. Statistics released by the tax authorities show that 61 percent of corporations pay less than PTE 30 million a year (EUR 149,639). In an attempt to address this perceived problem, several measures were taken:

- the general antiavoidance rule (GAAR) was clarified;
- the bank secrecy principle has been derogated in specific cases; and
- the definition of a low-tax jurisdiction has been amended, as have specific antiavoidance measures.

B. The GAAR

First, the scope of Portugal's GAAR has been clarified and widened. It now stipulates that legal acts or agreements can be recharacterized for tax purposes if it is shown that they were performed using fraudulent means, abused legal concepts, or were carried out with the sole or principal objective of reducing, eliminating, or deferring taxes that would otherwise have been payable. In those cases, the tax payable should be equivalent to that which would otherwise have arisen.

C. Bank Secrecy Derogated

Currently, the law authorizes the tax authorities to have direct access to banking information relating to a specific taxpayer. Namely the tax authorities may obtain access when taxpayers refuse to show and evidence documents (that correspond to the accountant records that justify the tax returns) or when taxpayers benefit from tax incentives and it is necessary to verify that the requirements that justified the attribution of such incentives are met. In addition, the tax authorities may still have access to bank information if it is shown that:

- it is not possible to determine the taxpayer's taxable income by using direct methods of computation and the requirements foreseen in the law to use indirect methods are met;
- the income declared by individuals is not in line with the wealth manifested by them;
- there are reasons to believe that a tax-related crime has been perpetrated; or
- it is necessary to prove the good uses of public subsidies for tax purposes.

Taxpayers may, however, contest these decisions before the Court.

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D. Low-Tax Jurisdictions

There are now three categories of criteria that define a low-tax jurisdiction:

- it is included in a list of low-tax jurisdictions to be published by the Ministry of Finance;
- individuals or corporations are exempted from individual or corporate income tax or its equivalent in such jurisdictions; or
- the foreign tax paid by the individual or corporate body is equal to or less than 60 percent of the individual or corporate income tax that would be payable if the entity were resident in Portugal.

1. Deductibility of Payments Made to Entities Located in Low-Tax Jurisdiction

As a rule, the deductibility of payments made to entities located in low-tax jurisdictions will be denied.

This regime may also be used to challenge less conspicuous preferential tax regimes. Jurisdictions such as Belgium, Ireland, the Netherlands, or Spain may be classified as low tax jurisdictions when considering specific vehicles or transactions. Taxpayers may evidence — bear the burden of proof in this matter — that not only the transactions behind the payments were real, but also that the amounts paid respected the arm's-length principle and were reasonable. In those cases, the payment deductibility should be allowed.

According to the new law introduced on 1 January 2001, unsubstantiated expenses of resident companies are not only nondeductible but are also subject, separately, to an additional tax rate of 50 or 70 percent, depending on whether the resident taxpayer is subject to tax (or is an exempted entity). Unsubstantiated payments (characterized as expenses) to low-tax jurisdictions are subject to an additional tax rate of 35 or 55 percent, depending on whether they are made by individuals or by corporate entities. In case the deductibility is allowed this additional tax does apply.

2. CFC Rules Amended

Furthermore, the concept of a controlled-foreign corporation has been modified in accordance with the above criteria. Prior to this year's tax reform, income from controlled foreign corporations attributed to Portuguese residents corresponded to the net profit calculated in accordance with the tax rules applicable in the CFC's state of residence. If the CFC had no income, the Portuguese tax authorities could not question the deductibility of expenses and charges in its state of residence.

This rule had considerable impact in jurisdictions where no thin capitalization rules exist or where interest is fully deductible. A CFC's income must now be determined in accordance with domestic (Portuguese) law. An interesting point to consider is whether, in calculating the tax that would be payable in Portugal, one may consider more favorable domestic regimes (such as the holding company regime for SGPSs), or even domestic incentives, rather than the general corporate tax regime.

3. Thin Capitalization Amended

Thin capitalization rules have existed in Portugal since 1996. The rules were introduced to combat the erosion of the corporate tax base by subsidiaries of foreign parent companies. These rules will now apply when a nonresident entity holds, directly or indirectly, a participation of at least 10 percent in the share capital of a resident company or when a "special relationship," as the latter has been defined for transfer pricing purposes, exists between the two parties. Before this reform, these rules would only apply in cases when a participation of 25 percent in the share capital of the resident company existed. If the amount of debt to the foreign entity with whom a special relationship exists is more than double the amount of equity, the interest payments on the debt are nondeductible.

A derogation exists if resident companies prove that a transaction took place at arm's length, that is, that the company would have received financing under similar conditions from a nonrelated entity.

The terms under which a derogation can be granted have been clarified. The law now states that the resident entity must show that the same financing conditions would have been obtained from a nonrelated entity, bearing in mind the type of activity exercised by the company, the sector in which it operates, the size of the company, and the risk profile of the operation. ◆

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