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Portugal Breaks New Ground With International Tax Reform

by Francisco de Sousa da Câmara

Portugal's Committee of Experts presented its final report on international tax reform to the Portuguese minister of finance in March 1999 approximately one year after the committee's appointment. The committee was appointed by the minister of finance under Decision 7.135/98, dated April 13, 1998, as published in the government's official gazette in April 1998. The committee was formed to report on the current stage of international taxation in Portugal and, in particular, to propose new measures to create an efficient international taxation system.

According to the April 1998 decision, the committee was directed to consider the need to establish a simple and coherent tax system – to ballast the country's ability to attract foreign investment and make the Portuguese economy more competitive from a tax point of view. The committee was asked to focus particularly on the taxation of financial products and the Portuguese international business centers of Madeira and Azores. Fundamentally, the committee was requested to review the current regime and to propose new measures to increase the competitiveness of inward and outward investment.

During the first semester of 1999, other expert tax committees presented their reports concerning the introduction of a wealth tax and the amendment of the current income taxes regarding financial and derivative products. At the end of the day – the sunrise of such a day will certainly be after the general elections to the Portuguese Parliament in October 1999 – it will be necessary to synthesize all these proposals for purposes of amending the current system in a coherent and consistent way. All the measures should form part of the same puzzle and, hopefully, come together to create a solution.

Focusing on the international tax reform report, this article will provide a general overview of the proposals under discussion relating to income tax treaty issues.

I. Income Tax Treaties

A. Current Stage

Within the context of the report, the minister of finance decided on July 17, 1998, to make an outspoken public statement. That is, the minister stated that Portugal has to abandon its old-fashioned policy of negotiating treaties, in particular its automatic assumption of the role of a mere importer of capital. During the 1960s and 1970s, bilateral treaties negotiated by Portugal were based on the OECD report entitled "Draft Double Taxation Convention on Income and Capital." Currently, the conventions negotiated by Portugal also include hybrid provisions inspired in the most recent OECD model income tax treaties (dated 1997, 1992, etc.), as well as the U.N. model. Nevertheless, the Portuguese tax treaty network is still the least extensive in the European Union, as is shown in the table below:

Tax Treaties Signed by Portugal[1]

Other Contracting State	Date of Signature	Date of Entry Into Force	Subsequent Amendments	
			Date of Signature	Date of Entry Into Force
Austria	12/29/70	2/27/72		
Belgium	7/16/69	2/19/71	3/6/95	
Brazil	4/22/71	10/10/71		
Bulgaria	6/15//95	7/18/96		
China[2]				
Czech Republic	5/24/94	10/1/97		
Denmark	3/3/72	12/22/73		Terminated 1/1/95
Finland	4/27/70	7/14/71		
France	1/14/71	11/18/72		
Germany	7/15/80	10/8/82		
Hungary	5/16/95			
India				
Ireland	6/1/93	7/11/94		
Italy	5/14/80	1/15/83		
Korea	1/26/96	12/21/97		
Morocco	9/29/97			
Mozambique	3/21/91	12/5/93		
Norway	6/24/70	10/1/71		
Poland	5/9/95	2/4/98		
Romania	9/17/97			
Spain	5/29/68	3/26/70	New treaty 10/26/92	6/28/95[3]
Switzerland	9/26/74	12/17/75		
United Kingdom	3/27/68	1/17/69		
United States	9/6/94	12/18/95		
Venezuela	4/23/96	1/9/98		

[1]This list is not updated with official data; it is possible that a few other treaties have been recently signed.

[2]The dates of signature were not available.

[3]Except to interest, which entered into force on 1/1/93.

B. Tax Treaties Under Way

Almost 10 years have passed since the Ruding report came to light in the European Union with its express recommendations: "The Committee urges Member States not only to conclude bilateral income tax treaties where none exist between them, but also to complete those where their coverage is limited."

Portugal has not yet concluded treaties with five EU countries — Denmark, Greece, Luxembourg, the Netherlands, and Sweden.

It seems that the process of negotiations with Greece and Luxembourg are in the final stages, if not technically concluded and the other three treaties have already been discussed in 1999.

In 1997 and 1998, treaties were signed with China, India, and Romania, and they are now awaiting parliamentary approval. Despite the lack of information released by the authorities, it is known that nine other treaties are also almost or definitively concluded on a technical basis — that is, the ones to be signed with Algeria, Cabo Verde, Canada, Pakistan, Russia, Slovakia, South Africa, Tunisia, and Ukraine.

Several other treaties are at an early stage of negotiation, and the ministry of finance continues to maintain a "policy of silence" both in relation to the main aims it wishes to achieve (regarding the treaties as a whole or each treaty per se) and in relation to the solutions adopted after the conclusion of negotiations and before their approval by Parliament. While this silence may be justified in the first type of situation, it is not justifiable regarding the second type. When tax treaties are sent to Parliament for approval, there is no point in maintaining secrecy.

C. Disclosure of Information and Explanatory Introduction to Treaties

More transparency, certainty, and participation should be rallying cries to lead the authorities to divulge and explain the way that agreements have been signed and what they contain. Unfortunately, this pattern is not followed, and even after publication and enforcement, tax treaties are not accompanied by clear and self-explanatory rulings or guidelines regarding the procedure by which they should be implemented.

As a rule, the mechanics for granting treaty relief are explained some time after the treaty's publication by an administrative guideline (a circular), which follows the format of the first circular model published in the 1970s and which does not cover all types of problems. These guidelines are mere administrative rules and cannot override legal or conventional provisions.

II. New Committee

The recently released international taxation report strengthens the need to create a special committee (the so-called "Double Tax Treaty Committee" or DTT committee) formed by elements from the Ministry of Finance, Secretary of State for Fiscal Affairs, and the Foreign Ministry to be responsible for the following tasks:

to analyze and determine the political interest in the signature of a treaty;

to obtain economic information about the bilateral relationship between both countries;

> to facilitate the judicial and diplomatic formalities for the entry into force of treaties already negotiated; and
>
> to express an opinion about the clauses that have been difficult to negotiate and to consider what clauses within those cannot be relinquished.

III. New Approach to Negotiations

The report also added its vote of support to the government's decision to abandon the former strategy and policy regarding the negotiation of treaties and to introduce a new approach. In view of the evolution of the Portuguese economy, which is moving toward the exportation of capital, Portugal should no longer assume the position of a mere state of source. In fact, statistics show that Portuguese companies are increasingly entering international markets especially in Africa, Brazil, and Spain.

Therefore, the new approach to be followed should bear in mind the following aspects:

> to adopt a pragmatic stance during treaty negotiations;
>
> not to consider the reservations introduced by Portugal on the OECD model convention as rigid and non-negotiable principles;
>
> to adapt proposals according to the applicable bilateral economic relationship;
>
> to obtain precise information regarding the economic impact of the signature of each clause regarding the bilateral relationship, requesting information from the official departments;
>
> to always consider and balance the economic, financial, and political pros and cons associated with each negotiation; and
>
> to keep the special DTT committee well-informed as to the stages of negotiation and to request its opinion on relevant matters.

IV. New Areas of Intervention

It is to be expected that international tax policy in Portugal will change, provided the current proposals are adopted. Within this context, both conventional and domestic tax law on international matters will need to be adapted in several points, as follows.

The treaty terms "dividends," "interest," and "royalties" that will be negotiated in the future will probably become wider in definition — to include new realities considered by domestic law. On the other hand, it is possible that high withholding taxes will not be defended as a peremptory principle in relation to payments from companies in Portugal to persons resident in a foreign treaty country. EU directives may contribute to the shape of this initiative. Beginning on January 1, 2000, Portuguese subsidiaries of EU parent companies cannot withhold taxes on the distribution of dividends. In this author's opinion, the so-called substituted inheritance and gift tax (a 5 percent withholding tax applied to the distribution of dividends by corporations) would also not be applicable. The coexistence of this tax, together with the domestic legal provision that implemented the EU Parent Subsidiary Directive, has already been brought before the European Court of Justice, and this court is expected to rule that Portugal is already infringing EU law. However, the EU proposal of a directive on the payment of interest and royalties [COM (1998) 67 final, OJ C 123,22.4.1998] still maintains a period during which Portugal may maintain withholding tax for five years; however, under treaty provisions, royalties will probably continue to be subject to withholding taxes in Portugal.

The Portuguese domestic definition of permanent establishment is larger and more all-embracing than the OECD model definition, and the international tax reform report suggests the adaptation of the domestic definition in accordance with the OECD model as it was before the introduction of the Portuguese 1989 tax reform package.

Certain undetermined concepts existing in the Portuguese domestic provisions, such as the term "special relationships," should be clarified. In this particular case, the term should be similar to the relationship definition involving "associated enterprises."

The committee states that OECD guidelines should be expressly followed and it proposes the creation of an advance pricing agreement process.

Despite some discussions at the committee level, the proposal suggests that taxpayers should be invited to participate in the procedures to avoid double taxation for purposes of turning the mutual agreement procedure into an efficient method of avoiding double taxation.

The introduction of specific rules on cost-sharing agreements has been suggested.

The committee has suggested the creation of specialized groups in transfer pricing under the auspices of the tax authorities services organization.

Finally, the committee recommends the reintroduction of safe-harbor rules regarding the payment of interest and royalties abroad.

Conclusions

The international tax reform committee's report presented by the Committee of Experts indisputably represents an important landmark in Portugal's bid to sweep aside the archaic international tax policy of the 1960s. This committee, led by Chairman Alberto Xavier, has helped to show that the dynamics of the Portuguese economy can no longer shoulder the burden of the archaic policy dialogue of the 1960s. As a full member of the European Union and with an economy that is annually expanding in terms of outward investment, Portugal can no longer behave as a mere importer of capital.

Although tax sparing clauses have already been introduced in some Portugese tax treaties (for example, in its treaty with Mozambique), Portugal should become more vigilant in the taxation of foreign income of their residents, unless incentives are justified to promote investment abroad.

Within the Portuguese tax system's struggle for reform, the priority for international tax policy should be consistency and coherence within the macroeconomic landscape. However, the answer to the question of whether Portugal will spread its treaty network along the new lines suggested by the Committee of Experts' report is a piece of the puzzle that, for the time being, is still missing. ✦

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