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Portuguese Budget Introduces Changes Regarding International Services

by Francisco de Souse da Câmara

Portugal's Socialist government presented the 1997 budget bill to Parliament as Proposal of Law No. 60/VII of October 15. Other than minor amendments motivated by political negotiations, no substantial modifications to the proposal are expected. Quoting political speeches, the press continues to sell the idea that the budget proposal does not increase taxes, based on the fact that the current tax rates are maintained (adjusted for inflation) or even decreased. This may be true in the case of the corporate income tax (IRC), whose nominal rate may be reduced in 1997, given that the government will receive an express authorization to reduce the IRC rate from 36 to 34 percent. However, marring this idyllic scenario, other proposals have been presented that will broaden the basis of several taxes (including the income tax, stamp tax, and other indirect taxes), reduce personal exemptions, increase the discretionary powers of the tax authorities, and reverse the burden of proof on crucial issues.

These measures are justified as efforts to provide equal treatment to all taxpayers and to fight tax evasion, but commentators have found other motives, namely "budgetary reasons."

International Services

Withholding Tax

One of the main proposals in the budget bill is to grant powers to the government to introduce a withholding tax of 15 percent on payments to nonresident individuals or corporations without a permanent establishment in Portugal for services performed or used (i.e., rendered abroad for the benefit of Portuguese residents) in Portugal. Until now, following a tradition that has existed in Portugal since long before the introduction of the new income tax in 1989, these payments were not subject to tax in Portugal (the source state), but only in the state of residence of the recipient.

Basically, Portugal had three main regimes applicable to international transactions. First, transfer of technology agreements such as licenses or know-how agreements involving the payment of royalties abroad were subject to a 15 percent withholding tax, provided no tax treaties applied to reduce the general tax rate. Second, the domestic rate of 15 percent was also applicable when payments for technical assistance were made to entities located in countries that did not enter into tax treaties with Portugal. Otherwise, as a general rule, those payments would not be taxed in Portugal as the source country. Third, payments deemed to be fees for services rendered in Portugal by nonresident entities were not subject to withholding tax in Portugal, regardless of the application of a specific convention.

The new measure will change the current scenario drastically. Once it goes into effect, fees paid in connection with services performed by entities resident in countries that have not entered into a bilateral tax treaty with Portugal become taxable at the source. Moreover, the payor of those fees will be responsible for the tax and the corresponding penalties if he does not withhold the tax.

Companies from several EU member states, including Luxembourg, the Netherlands, and Greece

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will be discriminated against within the European Union if no specific measures against this discrimination are adopted, because Portugal has not yet signed tax treaties with those countries.

In spite of the existing freedom to provide services in the EU market, services provided by companies from these countries will be discriminated against by the new tax barriers. In effect, in such cases income flowing from Portugal to the Netherlands or Luxembourg will be subject to a new domestic measure (15 percent withholding tax) increasing the likelihood of double taxation.

Aside from being contrary to EC goals, including those expressly mentioned in the Ruding Report, this measure could also be seen as contrary to articles 6 and 59 of the EC Treaty of Rome, because other EU member states (i.e., those that have entered into tax treaties with Portugal) may take advantage of these bilateral conventions to prevent double taxation.

Moreover, since Portugal has signed some tax treaties with non-EU member states (including the United States), one can easily understand that an American parent company with an active European holding company in Luxembourg or the Netherlands would prefer to incorporate a new holding company in Spain or in France, or that it would render the services directly from the United States because withholding tax could then be avoided, in accordance with the new U.S-Portugal treaty, whose provisions apply since January 1, 1996. It will not suffice to say that any relief granted by Portugal to American companies under their bilateral tax treaty must be granted to Netherlands or Luxembourg companies as well; the Portuguese tax authorities must explicitly adopt this interpretation.

An interesting discussion could arise concerning whether more sophisticated international payments, such as engineering fees or fees paid in the context of cost-sharing agreements, would be taxed or not. At least they will not be improperly recognized as royalties any longer.

Deduction of Payments for Services Abroad

In general, all business payments are deductible, provided the arm's length principle is respected. In this regard, domestic law (article 57 of the Corporate Income Tax Code) follows article 9 of the OECD model convention on income and on capital. Nevertheless, unsubstantiated expenses are not only nondeductible but also subject to a 25 percent flat tax rate. The budget bill for 1997 proposes to increase this rate to 30 percent, unless the payor is subject to corporate income tax and is exempt from tax. In that case, the payor will be subject to a flat rate of 40 percent, according to the proposal.

Last year, the government enacted a new rule to fight international tax avoidance, introducing article 57-A of the Corporate Income Tax Code. This rule disallows the deduction by domestic entities of some payments to companies located in low-tax jurisdictions (i.e., territories where those companies are subject to a tax rate of 20 percent or less, or are exempt from tax altogether) unless they prove that the services rendered by the companies were real and the fees respected the arm's length principle. This rule reverses the burden of proof, placing it not on the tax authorities but on taxpayers, which, in certain cases, could represent a diabolica probatio. The tax authorities may request proof from taxpayers, but should grant at least 30 days to allow the latter to gather all the necessary documentation.

Multinationals and other companies that make payments abroad should pay particular attention to the way future payments are made. Otherwise, surprises could arise, and additional assessments stating that no deductions were available and that withholding tax was due may be issued. The payor will then suffer all tax consequences. ◆

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