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Portugal Enacts Safe Haven Exception to Thin Capitalization Rules

by Francisco de Sousa da Câmara

Portugal has enacted thin capitalization rules (included in the Portuguese Corporate Income Tax Code (CIRC) as article 57:-C) to prevent tax evasion. These rules, effective February 3, 1996, have now been tempered with safe haven rules that provide exceptions to the application of the thin capitalization regime.

The legal authorization granted by Parliament to the government to introduce thin capitalization rules (Law 39-B/94 of December 27, 1994) did not result in the enactment of complete rules. The first measure, denying the tax deductibility of excess interest, was implemented, while the second measure, which would have allowed excessive interest to be taxed as a dividend, was not implemented. The initial fixed debt/equity ratio (Decree Law No. 5/96 of January 29, 1996) has been relaxed with the introduction of safe haven rules in Law No. 10-B/96 of March 23, 1996.

Except in the limited circumstances described below, when direct or indirect financing provided by a nonresident to a related Portuguese company exceeds a debt/equity ratio of 2:1, the interest paid on the excess financing may not be deducted by the payor (CIRC article 57:-C). For purposes of article 57:-C, the expression "related companies" includes:

- Portuguese companies in which the nonresident company or entity has a direct or indirect participation of at least 25 percent of the capital of the other company;
- Portuguese companies over which the nonresident entity exercises a significant decision-making power; and
- Portuguese and nonresident entities that are both subsidiaries of the same parent company, i.e., they are owned or controlled, directly or indirectly, by the same shareholders.

Related-party status also is deemed to exist when a loan is made by a nonresident third party to the Portuguese entity, provided the third party has received some kind of guarantee (e.g., a bank guarantee) from the nonresident entity.

According to article 57:-C (4), the debt/equity ratio and therefore the excess debt must be calculated in relation to any point in the tax period, and should be computed with respect to each taxpayer. It appears that this test may be made only by the tax authorities at the end of the tax period, or during an audit. Nevertheless, if the debt/equity ratio is exceeded at any time during the tax period, excess interest paid will not be considered a deductible expense.

Financing includes all kinds of financing (in cash or in kind, including commercial transactions in which the credit or the payment period exceeds six months) provided by nonresident entities to a resident related party.

The 1996 budget bill (Law 10-B/96 of March 23, 1996) introduced safe haven rules that will prevent application of the thin capitalization rules, even if the debt/equity ratio of 2:1 is exceeded, if the company can prove that it could have received financing from a nonrelated institution under the same conditions as provided by the related entity. This evidence should take into consideration the type of activity performed by the company (e.g., manufacturing industries cannot be treated as service industries or financial institutions); the size of the company; and other relevant criteria. Any relevant evidence should be presented within 30 days after the closing of the financial year, in accordance with CIRC article 57:-C (8). ◆

♦ *Francisco de Souse da Câmara, Morais Leitao & J. Galvao Teles, Lisbon*