PORTUGAL

CFC Taxation

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I. INTRODUCTION

Following Portugal's comprehensive tax reform enacted on 1 January 1989,[1] several changes were introduced concerning both domestic and international taxation which reflect the increased attention being paid to anti-avoidance measures. Portugal's high tax rates and its comprehensive income taxation have led taxpayers to seek the benefits of low-tax jurisdictions. The Portuguese tax authorities, for their part, have become increasingly aware of the practical effects of the use of tax havens: the creation of budgetary gaps as well as economic distortions. In addition, it has been recognized that tax havens create new possibilities for avoidance and (indirectly) make some taxpayers bear the burden of tax for others.

The recent introduction of anti-tax haven rules was therefore most welcome. The measures discussed below have as their main objective preventing avoidance of domestic tax through the creation of controlled foreign corporations ("CFC") established in tax havens. They are applicable from the tax year 1995. Although these provisions are included in the recent anti-tax haven rules, they are only a small part of the broader trend toward combating the use of low-tax jurisdictions.[2]

In addition, in spite of some inconsistencies (as will be seen), Portuguese policy in this field also contains general features found in treaties to avoid double taxation (e.g. treaty shopping measures or provisions excluding specific territories), along with implementation of the Parent-Subsidiary Directive (Article 2) and the exchange of information directive.[3]

II. THE LAW

A. CFC regime

Policy objectives

The main objective is to eliminate the benefits of tax deferral for passive (investment) income or other base company income received by CFCs and to prevent the diversion of passive and certain base company income to CFCs.

Definition and attribution of income

For Portuguese tax purposes a CFC is an entity located in a low-tax jurisdiction (subject to a tax rate below 20%, including exempt companies) and controlled by Portuguese residents (individuals, corporate participators)[4] whenever these latter own, directly or indirectly, at least:

- 25% of the capital; or
- 10% thereof, where more than 50% of the capital is held by Portuguese residents.

Article 57B CIRC refers expressly to resident participators, thus leading the conclusion that this regime is applicable to individuals or corporate participators, but that it does not include non-residents such as a Portuguese permanent establishment of foreign entities. In addition, it seems that it does not apply where the foreign entity has not been formed as a company (for example, when it was set up as a different kind of foreign entity – a foundation).

Up till now the Portuguese tax authorities have not published a black list of the low-tax jurisdictions[5] and, in order to preserve flexibility, probably will not do so in the future. However, for the time being, one may argue that because of the wording of Article 57B(3) no particular problem will arise if a foreign company is allowed to choose the tax rate (e.g. 20%) and to be subject to tax so as to keep outside the Portuguese CFC provision.

Attributed income

Regarding the taxation of Portuguese residents, Article 57B CIRC provides that "profits resulting from the activities of a CFC shall be taxable in the hands of its resident members and shall be attributed to them in the proportion

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1. The schedular system was replaced by the Individual Income Tax (IRS) and the Corporate Income Tax (IRC). Subsequently the tax infringement and penalty regime was also amended.
2. In the same drive against low-tax jurisdictions two other rules are on the way: the first allows the authorities to recharacterize interest as dividends (constructive dividends); the second prohibits domestic entities from deducting some payments made to companies located in low-tax jurisdictions as tax charges; while the first measure still needs to be implemented by the government and authorized by the Parliament, the second one is already part of the Corporate Income Tax Code (CIRC) (Articles 57A CIRC).
3. This article does not discuss the compatibility of CFC provisions with international tax law. Under Portuguese constitutional law domestic law cannot override international law. However, CFC rules do not fall within the treaty framework and are thus permissible. See "International Tax Avoidance and Evasion – Four Related Studies" in *Issues in International Taxation*, No. 1, (Paris: OECD), 1987.
4. A company entity is a resident in Portugal whenever it has its head office or place of effective management in Portugal. The territory of Portugal comprises mainland Portugal and the Autonomous Regions of Madeira and the Azores. Permanent establishments such as branches are not residents. An individual is deemed to be a resident of Portugal if: (a) he remains there for more than 183 days in any calendar year; (b) he visits Portugal for a shorter period in any year in which he has available a place of abode on 31 December of that year and from the circumstances it can be inferred that his intention is to keep and occupy such abode as his permanent residence; or (c) he is, on 31 December of any year, a crew member of a ship or aircraft operated by a resident legal entity.
5. A list has been published referring to the jurisdictions which may not benefit from corporate or individual income tax exemptions for interest received from certain Portuguese public bonds (Portaria 377-B/94 of 15 June 1994).

laid down in the CFC formation contract". Portuguese residents may therefore be taxed even if no dividends are distributed by the CFC. This technique is similar to the tax transparency regime in several countries as well as to the taxation of the European Economic Interest Grouping (EEIG).

Like CFC legislation in other countries, the Portuguese anti-tax haven legislation (in particular, Article 57B CIRC) does not encompass active business income nor does it aim to interfere with the ability of Portuguese taxpayers to compete internationally. In fact, the CFC veil cannot be lifted by the Portuguese authorities in order to tax active business income, which continues to benefit from the deferral regime. On the other hand, passive income, including income realized by base companies, is – despite the exceptions analysed below – attributed to resident participators (members) in the CFC, provided certain requirements are met.[6]

Jurisdictional or transactional approach?

In introducing anti-tax haven rules, the Portuguese regime has predominantly followed the jurisdictional or entity approach. This focuses much more on the CFC's country of residence and on the tax regime where the latter is located than on the type of income earned.[7] However, one should note that neither of these approaches is exclusively applicable. The Portuguese case is representative and follows other European examples (such as the French and the English) which exempt persons engaged in industrial or commercial activities (i.e. active business income) from the CFC regime.

In adopting predominantly the jurisdictional approach, the Portuguese legislator probably tried to reduce the administrative and compliance burdens. There are, however, still several difficulties, viz.:

- analysis of the indirect percentage held by residents;[8]
- determination of which foreign jurisdictions apply a zero rate of tax or a tax rate below 20%;
- inclusion or exclusion of certain types of income earned by the CFC in particular because parties will try to convert tainted income into active business income.[9]

B. Exceptions to CFC regime

Overview

As indicated above, the jurisdictional approach adopted by Article 57B CIRC is not absolute. On the contrary, there are several exceptions to it. Firstly, just by looking at Paragraph 4 of these same provisions, we can distinguish a large number of situations that do not fit under the entity approach. Secondly, since in tax law the legality principle and non-discretionary authority must be taken into account, the legislator's aims of necessity cannot include all the cases that may have occurred to "mens legis". Finally, Article 3 of Decree-Law 37/95 of 14 February 1995 provides that as long as the territory of Macau remains under Portuguese administration (i.e. until December 1999), a company established there is understood not to be subject to a clearly more favourable tax regime[10] whenever its profits are taxed at a rate of no less than 15% and no more than 20%. This is not exactly an exception to the rule of Paragraph 1, but rather a nuance in the legal definition of tax haven. This has repercussions (indirectly) for the scope of the general regime.

Tainted and non-tainted income[11]

Paragraph 4 of Article 57B CIRC provides an exception to the CFC regime,[12] if the following two conditions are met simultaneously:

- at least 75% of the CFC's profits are derived from an agricultural or industrial activity in the territory where it is registered, or from a commercial activity with no activity on the part of residents in Portugal;[13]
- the non-resident company's main activity does not comprise certain operations specified by the law, such as:
  - banking (even if not carried out by credit institutions);
  - insurance (provided the underlying income is derived from insurance for commodities/products located outside the CFC's residence territory, or from insurance relating to persons who are not resident in that territory);
  - holding of participating interests or other securities, intellectual or industrial property rights, or rights relating to know-how or technical assistance; and
  - rental of assets (except immovable property situated in the CFC's country of residence).

Possible legal gaps not filled by Article 57B(1) CIRC derive directly from the nature of the resident entities covered, the nature of the income obtained by the CFC and from the possibility to characterize the CFC's activity.

6. Portuguese law does not recognize exemptions for CFCs which are not based exclusively on the income earned by the corporation. Thus, common exemptions recognized internationally (such as (a) an exemption for CFCs that distribute a certain percentage of their income for a year; (b) an exemption for CFCs whose shares are traded on a stock exchange; (c) a de minimis exemption where the total income or tainted income of a CFC or a participator's *pro rata* share of such income does not exceed a certain amount; (d) an exemption for CFCs that are not established or operated for the purpose of avoiding domestic taxation) could only apply provided they are explicitly inserted in Article 57B(4) CIRC.
7. Traditionally, this jurisdictional approach is the opposite of the transactional approach which looks directly at the nature of the income earned by the CFC. Often, when this particular income is directly attributed to shareholders without the benefit of deferral, such income is referred to as tainted income. We will also use this term as opposed to "non-tainted income" which is predominantly active business income.
8. If the CFC is not a personal holding company, it is sometimes difficult, even for resident members, to obtain information because of anti-disclosure rules existing abroad.
9. See *supra* note 6.
10. This concept is explained in Article 57B(3) CIRC, see above.
11. See *supra* note 6.
12. The exemption is both qualitative (the nature of the income) and quantitative (75% of profits must derive from the qualifying activity) but problems arise with respect to the proof to be submitted. No guidelines exist at all at this moment with which to fill in these concepts and it will be some time before the situation is entirely clear.
13. However, the exception is still valid in spite of the participation in such activities by residents in Portugal as long as the activity is predominantly directed toward the tax haven market (Article 57B(4)(a) CIRC).

C. Interest of a resident-participator

Direct and indirect participations

The CFC regime will be rather easy to apply as long as a participator controls directly a participation of 25% or more and complies with filing requirements. It will not be so easy to apply the CFC rules if the participator does not fulfil its filing requirements. Problems will surely arise in determining whether more than 50% of the CFC's capital is held by residents. Moreover, it is quite a complex task to verify the degree of control if applicability of the regime depends on the compliance of several residents with participations between 10% and 25% held directly or indirectly. It is even more difficult to find out the percentage held by residents if part or all the control is exercised through a long chain of intermediary holding companies.[14]

The ownership requirements must be met at the closing date of the CFC's tax year[15] and will have an impact on the resident taxpayer's current tax period.

Article 57B does not clarify how the indirect percentage is to be calculated. However, it is likely that this percentage is obtained by calculating the direct percentages and multiplying them by the succeeding participations among themselves (i.e. by pyramiding the holding).[16]

Participators and beneficial owners

Finally, other problems will arise with the personal interposition of foreign entities. Portuguese law does not expressly allow the tax authorities to disregard the interposition of a company indirectly held by a resident beneficial owner through a trust. Under Article 57B CIRC, it seems that the Portuguese resident must always be a participator in a foreign company. Not only does the wording of the law refer to "members (participators) of CFCs" but it also implicitly provides that residents effectively participate in such companies and are not merely beneficial owners. Therefore, in our opinion, the concept "indirect participators" cannot include beneficial owners. Besides, further complexities (or impossibilities) would arise in attributing the CFC's income to those who are not participators and who could hypothetically receive a small part of the cake. In addition, it seems that beneficial owners of CFCs cannot be treated in the same way as participators, because Article 57B does not oblige them to comply with filing requirements.

The concept of legality (Article 106 of the Portuguese Constitution) and the right to organize one's affairs so as to minimize taxes should be enough to prevent the authorities from extending tax law provisions through administrative regulations. On the other hand, it should not be forgotten that Portuguese law follows the universality principle of taxation obliging resident taxpayers to declare all income generated in Portugal or abroad whenever they receive it. Therefore, the sole discrepancy between the tax treatment of resident participators and beneficial owners of CFCs is that the former are obliged to attribute income even when dividends are not paid and that the latter may benefit from tax deferral. For the time being there are no legal provisions giving them the same tax treatment and the fictitious interposition theory is not tenable provided there seems to be no simulation or tax fraud in such arrangements.

III. FOREIGN TAXABLE INCOME SUBJECT TO IRC OR IRS

A. Determination of profit

One of the most important questions is whether profits derived by the CFC and to be attributed to Portuguese-resident individuals or corporations must be calculated according to the foreign or the Portuguese tax rules.

Article 57B(2) CIRC provides that the income to be attributed to Portuguese residents corresponds to net profit (after taxes) calculated according to the tax rules applicable in the CFC's residence state (i.e. according to the legal system of the tax haven).

This method was probably chosen to avoid the practical difficulties arising from an attempt to apply Portuguese rules to the calculation of the CFC's profits. Therefore, if the CFC has no income (e.g. costs are higher than profits), no income can be attributed to Portuguese residents. On the other hand, the Portuguese authorities cannot discuss the types and kinds of tax costs or the amounts of tax charges and expenses incurred by the CFC (i.e. the rules on depreciation, provisions as well as the rules on deductible business expenses are established according to the CFC's residence state). This situation will have an extraordinary impact on jurisdictions where it is possible to manipulate the tax base (e.g. where interest is fully deductible and where there are no thin capitalization rules).

Consequently, foreign income is only attributed to Portuguese residents when obtained by a CFC in accordance with the foreign income tax rules and must be attributed within the Portuguese tax period in which the annual accounts of the CFC are approved.

Foreign income attributed to individuals is treated as net business or agricultural income where the foreign participation is allocated to a business or agricultural activity and is treated as investment income in all other cases. Accord-

14. This is more difficult to analyse in the Portuguese regime, because the mere holding of 10% of the CFC's capital by one person triggers applicability of this regime if 50% of the company is owned by residents. In addition, if this is the case and one individual or company does not declare its participating interest, it becomes impossible to apply this rule. In any case, such a situation is also almost impossible to verify because foreign bearer shares can be sold without formalities and, in general, information is not disclosed.

15. Would it be possible for Portuguese residents to swap their participating interests in order to prevent applicability of the CFC regime (i.e. could residents sell their shares in the CFC before the end of the tax period and acquire the same shares again in the next tax year) for the sole purpose of avoiding taxes?

16. Domestically, this regime already allows tax consolidations when 90% or more of the company is controlled directly or indirectly – see Article 59 CIRC. No guidelines whatsoever exist to determine if the "indirect percentage" could be replaced by "an indirect control" through a personal fictitious interposition. Therefore, within the limits and constraints mentioned below, the Portuguese tax authorities and the courts will have to decide about the precise meaning of this "indirect holding" of participating interests. Thus, *inter alia*, the parameters will be the principle of legality, the bona fide principle and the autonomy of taxpayers as opposed to the abuse of law, simulation and *fraus legis* principles.

ing to general principles it seems that this foreign-source income is included as "net income" in the individual's business or farming taxable income or in the corporation's taxable income.

B. Relief from double taxation

Transparency regime

Distributions

Under the CFC regime, any resident holding a relevant participation in the CFC is deemed to have received his share in the CFC's income pertaining to the relevant assessment period in which the CFC closed its annual accounts even if such a share has not been effectively paid to him (e.g. it is paid into a reserve account or used to make further investments). The resident would accordingly be taxed in Portugal.

Since the CFC's profits, whether distributed or not, are taxed to those Portuguese residents, in order to prevent double taxation, the future distribution of profits to them does not generate any further tax. Each time a resident shareholder receives a real distribution of dividends he will deduct from his taxable income and up to that limit, the profits already attributed in the previous years. For this purpose the resident should have clear accounts summarizing its position *vis-à-vis* the profits already attributed to and the dividends distributed by the CFC.

Capital gains

There are no measures to avoid double taxation through the sale of CFC shares or comparable interests.

Capital gains are subject to tax when taxpayers realize them on the sale of assets (e.g. if the value of the realization is higher than the value of acquisition). In this particular case the law does not provide that a gain from the sale of participating interests in the CFC in a future year should be calculated for tax purposes by subtracting from sale proceeds not only the amount of the acquisition value (original book value is subject to correction for inflation) but also the undistributed earnings upon which he was subject to tax. Thus, because the taxpayer is not allowed to increase the value of his CFC holding by the amount of earnings less the sum of distributions received during the year, he could be subject to double taxation.

Avoidance of international juridical double taxation

A Portuguese resident may benefit from a unilateral measure or from treaty provisions (if applicable) to avoid international double taxation.[17]

Under the unilateral measure recently introduced in the CIRC, a Portuguese resident corporation is granted a tax credit which is limited to the lower of the following amounts:

(a) the foreign income tax paid; or
(b) the fraction of the IRC liability, calculated prior to the credit, corresponding to the foreign income (taxable in Portugal).

This relief is granted in the year of distribution by means of a credit against IRC in an amount equal to the income tax previously paid (when the profits were attributed to the Portuguese resident) in Portugal. If the credit cannot be used, either totally or partially, in that year because there is no IRC liability (e.g. the company has losses or has other tax credits to be used first), the company may carry forward the unused tax credit over the next five tax periods.

In general, Portugal follows the ordinary credit method in its tax treaties on the avoidance of double taxation.[18]

Domestic double taxation

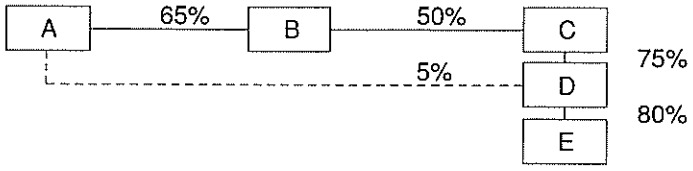
Again, Article 57 B CIRC does not clearly define how the regime works when two or more resident entities qualify indirectly (one or two through another one) for the CFC regime. If one or more resident individuals or companies own indirectly 10% or more of a CFC through the interposition of another resident company directly subject to the CFC regime, could the former entities be subject to tax on the basis of their indirect percentages?

This particular situation is not covered by Article 57B CIRC. In any case, despite this legal omission, it seems clear that two resident entities cannot be liable to pay tax for the same profits generated by the CFC. Any other interpretation could, in our opinion, be refuted on the basis of the concept of legality and the "non bis in idem" principle, both of which are anchored in the Portuguese Constitution.

C. Examples

Example 1

A Portuguese company A owns 65% of a Spanish company B which holds 50% of a Netherlands BV company C. The latter holds 75% of company D incorporated as an NV under the Netherlands Antilles law. This company owns 80% of a Cayman Islands bank E. In addition, company A owns directly 5% of the Netherlands Antilles company D.



Both companies D and E may be considered to be located in low-tax jurisdictions and neither is engaged in direct economic activity. Therefore, it is important to analyse the percentage held by the Portuguese company A in D and E. Company A has the following foreign interests:

- direct participations: 65% in company B
  5% in company D
- indirect participation in D: 65% x 50% x 75% = 24.375%

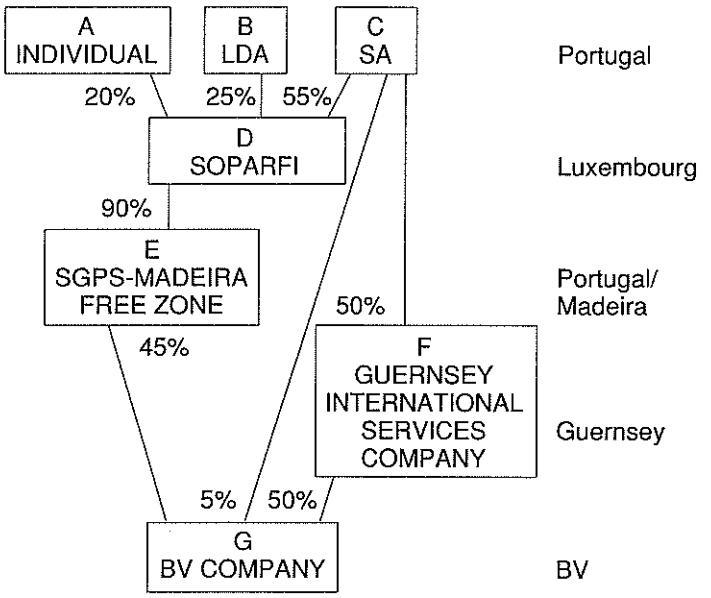
17. Individuals cannot benefit from any unilateral measure to avoid double international taxation because there is no provision in the CIRS like the one in Article 73 CIRC.
18. Until now, Portugal has not allowed a resident to obtain relief from economic double taxation in the international context.

- indirect participation in E: 5% + 29.375% x 80% = 23.5%
- total participation in D: 5% + 24.375% = 29.375%
- total participation in E: 23.5%

Company A qualifies for the purpose of Article 57B CIRC with respect to the participation in company D. Therefore, company A should declare 29.375% of the profits obtained by company D which will be included in its taxable income.

Company A, on the other hand, does not have a relevant participation in company E. It has only an indirect participation in company E and the latter is lower than 25%. Taking into consideration that the remaining 20% of the company E's capital is not controlled by Portuguese residents, company A is not covered by Article 57B CIRC in respect of company E.

Example 2



Soparfis (*Sociétés de Participation Financière*) are subject to tax. In spite of the special exemptions granted for dividends and capital gains it is clear that Soparfis cannot be treated as CFCs for Portuguese tax purposes.[19]

SGPSs are Portuguese-resident holding companies subject to corporate income tax at the general rate of 36%. Therefore, they cannot be considered CFCs. However, as resident companies they are covered by the CFC regime where they hold a participation in a foreign CFC. Problems could arise in determining whether the attributed profits may get the same tax treatment as distributed profits at the SGPS level.[20] In general, 95% of dividends and profits received by SGPSs may be excluded from their taxable base. In the author's opinion, both the letter and spirit of Article 41(1)(g) EBF allow an equivalent tax regime for such profits directly attributed and not yet distributed. However, it might also be considered reasonable to distribute dividends directly from a foreign CFC to the Portuguese SGPS in order to benefit from the distribution tax regime with no need for further discussion regarding the interpretation of legal provisions.[21]

The percentages owned by the Portuguese entities are as follows:

The Portuguese individual A holds:
directly: in D – 20%
indirectly: in E – 18% = (20% x 90%)
in G – 8% = (18% x 45%)

The Portuguese Lda B owns:
directly: in D – 25%
indirectly: in E – 22.5% = (25% x 90%)
in G – 10.12% (22.5% x 45%)

The Portuguese SA C owns:
directly: in D – 55%
in F – 50%
in G – 5%
indirectly: in E – 49.5% = (55% x 90%)
in G – 25% = (50% x 50%)
– 22.27% = (55% x 90% x 45%)
total in G = 52.27%

The Portuguese Madeira company SGPS E owns:
directly: in G – 45%

Are the profits realized by F and G taxable in Portugal under the CFC rules? How are they taxed and to whom are they attributed?

There are several types of non-resident company in Guernsey that could be considered to be located in a low-tax jurisdiction. However, international companies were introduced in Guernsey at the beginning of 1993 for other purposes. One of the most important was to ensure that a resident company would be taxed at an agreed tax rate of up to 20%. In this particular example, company F (Guernsey company) is taxed at a rate of 20%. Therefore, this company cannot be regarded as a company located in a low-tax jurisdiction.

Nevertheless, the BV could be said to be located in a low-tax jurisdiction. It is thus important to find out the relationship of the Portuguese resident entities A, B, C and E with the BV G.

The Portuguese resident individual cannot qualify for the CFC regime because he only holds indirectly 8% of the BV. B, C and E may qualify for this regime because all the

19. Being fully taxable and subject to IRC, the Portuguese subsidiary of Soparfi (company E) must, in the author's opinion, qualify for application of Article 166 LIR. If this is the case, dividends may cross from BV to mainland Portugal without taxation because no withholding tax or corporate income tax will apply – as explained above – in accordance with the domestic regime and the Parent-Subsidiary Directive.

20. Holding companies (SGPSs) established in Madeira Free Zone are exempt from IRC in relation to income derived from holdings in companies which are not resident in Portugal, except for those in the Free Zone or in the other Member States of the European Union. Therefore, that these SGPSs are companies which are not only subject to tax but which must pay effective taxes if they receive dividends from the Free Zone or from any EU Member State is unquestionable. Thus, the Portuguese legislator granted these companies the benefits of the Parent-Subsidiary Directive. In addition, such companies (SGPSs) are subject to corporate income tax on the capital gains realized on the sale of shares or quotas in the foreign companies in which a participation is held, because there is only a reference to "income derived from shareholdings" (Article 41(1)(g) of the Portuguese Tax Incentive Statute (EBF)) and it will be very difficult for anyone interpreting the law to stretch the term "income" to cover "capital gains" in this context. Alternatives are found in Francisco de Sousa da Camara, "Madeira Free Zone Legislation Amended" 34 *European Taxation* 1 (1994), at 2-9.

21. This may be avoided if the SGPS is located in Madeira Free Zone, except if the CFC is located in an EU Member State.

companies have a substantial participation (directly or indirectly) in the BV.

In this example, each of the resident companies would have to attribute the corresponding share of the CFC's profits in its taxable income, as follows:

Company B: 10.12%
Company C: 30%
Company E: 45%

The percentage held by C in G could be higher if company C buys the other 50% of the capital in company F. In such a case company C will increase its interest in company G to 50% (thus holding a total interest of 77.27%).

As indicated above, Portuguese law does not expressly allow avoidance of double taxation when two or more Portuguese companies own a CFC indirectly in a chain, (i.e. one through the other).

In our opinion, (as explained above) only the Madeira SGPS and company C have to include 45% and 30%, respectively, of the profits realized by the BV. Otherwise, the principle of legality and the concept of "non bis in idem" would be violated. In fact, indirect participations (such as those of company A and B) should be disregarded for CFC purposes, provided there is another intermediate resident entity (such as company E) already taxed or subject to tax on the same participation (e.g. in company G), according to CFC rules.

One could even argue – this is also valid for other tax transparency situations – that the CFC regime violates the ability-to-pay principle because no income is distributed. Besides, without taxable capacity all these companies could argue that the tax corresponding to their "ideal share of income" in G, which they should pay immediately without receiving any income, is in conflict with the Portuguese Constitution (e.g. the taxable capacity principle and even the right to property).

In fact, one cannot ignore that these resident participators may have to pay taxes in respect of income they will never receive. In addition, if they do not control the CFC they can generally take little action against the corporation's dividends policy.

Taking into consideration these comments the tax situation of Madeira Free Zone – SGPS (company E) and company C is as follows:

G closes its tax period	Tax Period of E	Tax Profits of G	Attribution to	Subject to tax	Tax due
31.3.95	31.12.95	100,000 *	E: 45,000	2,250	0
			C: 30,000	30,000*	11,880**

* C should include this amount in its tax base.

** This includes IRC (tax rate of 36%) plus municipal surcharge (3.6%).

Profits of company E should not be taxed because the Madeira SGPS (company E) is exempt from any income tax derived from holdings in companies which are residents outside the European Union.[22] However, company C will, in principle, have to pay IRC at the rate of 36% plus (when applicable) the municipal surcharge of 10%, which results in a gross tax burden of 39.6%.

IV. LOSSES

Article 57B CIRC does not allow Portuguese residents to deduct losses generated by the CFC. In addition, there is no provision allowing the CFC's losses to be carried forward or carried back.

V. PROCEDURAL MATTERS

As indicated above, qualifying participators in CFCs must declare and compute annually their CFC share in their personal taxable income. Up till now only corporate bodies were obliged to provide the tax authorities with information about their participating interests (if these were 10% or more) in other companies or entities.

Resident shareholders of CFCs must include the balance sheet and the profit and loss account together with the decisions adopted by the CFC's general meeting or board of directors (certifying that those accounts were duly approved by the competent statutory body)[23] along with their annual tax return.

Would all the exceptions to the CFC regime be enough to allow and prevent Portuguese residents from declaring a participating interest of more than 10% or 25% in a foreign corporation located in a low-tax jurisdiction? If it seems necessary to require a declaration in order to prevent abuse and to allow the authorities to verify and control the exception expressly indicated in Article 57B(4) CIRC (see II.B. above), it also seems clear that only those resident taxpayers subject to the CFC regime under Article 57B(1) are obliged to comply with filing requirements on their foreign participation and related profits. This situation is surely open to tax evasion or at least tax avoidance and the ambiguous way in which legal exceptions are worded will trigger problems with respect to the proof that should be presented by taxpayers in order to benefit from them.

VI. TAX EVASION AND TAX AVOIDANCE

As in other countries, it is essential in Portugal to distinguish tax fraud or tax evasion from tax avoidance, the latter being closely connected to legitimate tax planning.[24] Tax evasion is one or more illegal actions through which the taxpayer breaches his tax obligation (possibly in relation to more than one legal system).[25] Tax avoidance, in contrast, is the result of the use of an existing legitimate

22. *Id.*

23. Corporate taxpayers are required to file a final return with the competent local tax office for a given year in May of the following year. Any outstanding liability must be paid upon filing the annual return. For individuals with holding interests in CFCs, the filing deadlines are between 16 March and 30 April of the current year in respect of the year in question and the tax assessment should be completed by the authorities by the end of May.

24. Tax planning is sometimes referred to as "tax assembling", "tax architecture" or "tax engineering". See on this specific issue, Prof. Albert Xavier, *Direito Tributário Internacional*, (Coimbra: ed. Almedina, 1993), at 291–296 and 311–317, and Prof. Albert Rädler, "Do National Anti-Abuse Clauses Distort the Internal Market?", 34 *European Taxation* 9 (1994), at 311–313.

25. Tax evasion usually consists of making false declarations or simply of refusing to comply with tax obligations.

course of action (explicit or implicit, i.e. a loophole in the law) by farsighted taxpayers. It is precisely in the sphere of tax avoidance that the issue of tax havens comes up.

Of special interest is international tax avoidance that presupposes two facts:
- the existence of various tax systems, the particular circumstances of which one or more are more beneficial to the taxpayer than others; and
- the possibility the taxpayer has to make a choice between the applicable tax systems.[26]

In short, (international) tax avoidance[27] consists of legitimate planning by which the application of a certain tax rule is avoided by taking a series of steps that expressly lead to no obligation to pay tax in a certain country (with a disadvantageous tax system) by transferring it to a tax haven.

It is most important to stress that tax avoidance, in order not to become simple tax evasion, presupposes a degree of freedom on the part of the taxpayer. This basic fact allows us to distinguish legitimate planning from other legally unacceptable constructions, such as fraud, abuse of law and simulation.[28]

Reducing tax liability by legitimate tax planning

It is obvious that the domestic legislature, with the aim of increasing public revenue, may be interested in restraining the taxpayer's degree of freedom by laws that, one way or the other, discourage the systematic use of the opportunities granted by privileged tax systems. Once again, this is quite legitimate on the part of the government. The recent introduction of Article 57B CIRC in Portuguese law must be regarded in this light. Nevertheless, the tax authorities cannot eschew the basic constitutional principle of legality. This means that taxpayers will always have access to tax planning wherever the law has left a door open, either because of the options left open by those who wrote the law or due to the limitations inherent in legislations (the impossibility of foreseeing and covering all possible situations).

Even after Article 57B CIRC[29] came into effect, many gaps and blank spaces concerning tax havens remain. Those loopholes can be legitimately used by taxpayers in tax planning, thus forcing the legislator to make better law.

VII. PENALTIES

If resident participators qualifying for the CFC regime fail to declare this or to provide the necessary documents issued by the CFC along with their tax return, they are subject to severe fines which range from a minimum of PTE 10,000 to a maximum of PTE 800,000 (in the case of negligence) and PTE 20,000 and PTE 1,600,000 (in the case of an intentionally misleading filing). In addition, they can also be taxed by indirect methods (Articles 38, 50 and 16 CIRS and 51 and 52 CIRC), subject to additional sanctions (e.g. disqualification from receiving any public subsidy or credit or tax incentives during a period of up to two years).

Moreover, if a taxpayer fails to declare its share in the CFC's profits this could be considered tax fraud, which is a criminal offense. Tax fraud can be penalized by:
(1) prison up to five years applicable by tax courts, and
(2) fines.

VIII. CONCLUSIONS

The introduction of anti-avoidance measures was welcome. In fact, as the OECD points out:

> non-compliance is not only a threat to the honest taxpayer's professional activities by distorting competition but also to his private well-being and perception of fairness, since the greater the tax evasion or avoidance of others, the greater the share of taxation that has to be borne by the majority of taxpayers.[30]

However, the way the CFC rules were implemented in the CIRC looks like an effort to conciliate Cain and Abel. Incomprehensibly, the measures were introduced through a very brief legal provision (Article 57B CIRC), which, however, is so broad (e.g. these rules could be applicable to resident individuals or corporations owning merely 10% of the CFC company, directly or indirectly) that it leads to several omissions, gaps and loopholes.

As indicated above, a great number of opportunities are available to minimize a taxpayer's tax burden when investing in foreign companies even if they are located in what have traditionally been seen as low-tax jurisdictions. In spite of these considerations it is regrettable that there has been so little public discussion of subjects of such importance (the parliamentary authorization to the government was almost a blank cheque) and that much uncertainty remains because of the many unanswered questions.

26. This possibility of choice is seen in the legitimate (since it is not forbidden by the law) use of a connecting element contained in the conflict rule. It is worth noting that here there is a parallel with situations that are typical of International Private Law, since in both cases the choice of the applicable tax or legal system is at stake. Nevertheless, the convergence is not absolute: in International Private Law the choice of the ruling legal system is direct; in tax law the option is indirect. This indirect option consists of the transferring of a certain activity or production of certain facts, which are subject to heavy taxation in a certain territory, to another territory with tax haven characteristics.
27. The issue (and conclusions) are similar, all things being equal, regarding domestic tax avoidance.
28. In fraud there is a direct breach of the law (making false declarations, for instance); in abuse there is a presupposition of anti-social behaviour, which is not the case in tax planning which results from a degree of freedom concerning the means offered by the law to accomplish the legitimate interests of the taxpayer; in simulation there is a divergence between the real will and the declared will, which obviously does not occur in tax avoidance. At present, simulation is regarded as tax fraud in Portugal.
29. The advantages offered by low-tax jurisdictions are multiplied whenever they are covered by treaties on double taxation. Such is the case for the Madeira Free Zone, which benefits from such agreements signed by Portugal. In this particular situation, corporations can, in certain cases, receive the cumulative benefits of tax exemption on the income received, no (or lower) withholding tax on profits distributed among the shareholders and tax sparing clauses, when applicable.
30. See the OECD report "Taxpayers' rights and obligations" – a survey of the legal situation in OECD countries", (Paris: OECD, 1990).