

Portugal

A special report
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Portugal abandoned the dualistic or composite system of taxation and introduced a global income tax in 1989. Since January 1 1989 corporations have been subject to corporate income tax at a rate of 36.5% (now 36%). Individuals are subject to individual income tax with a marginal rate of 40% on income over Esc5,570,000 (US\$32,366).

With its new system of taxation, Portugal intended to embrace the idea of base-broadening and rate reduction reform with comprehensive income taxation and an equitable regime.

Unfortunately, horizontal and vertical equity has not been achieved. Taxation on interest, dividends and capital gains is far more benevolent than on salary. In addition, there are several differences in the tax treatment of employment income and self-employment income.

Moreover, in spite of stating that fees of members of corporate bodies (other than statutory auditors) must be considered as employment income, the law introduced some discrepancies between the tax treatment of income (including fringe benefits) received by directors and employees. Some of these differences are established by law, namely those concerning the social security regime, but others derive from lack of regulations, such as those on the fringe benefits.

Taxation of employment income

Resident taxpayers are subject to individual income tax on worldwide family income. In accordance with the accretion concept of income, the latter encompasses nine categories according to the source, as follows:

- employment income;
- self-employment income;
- business income;

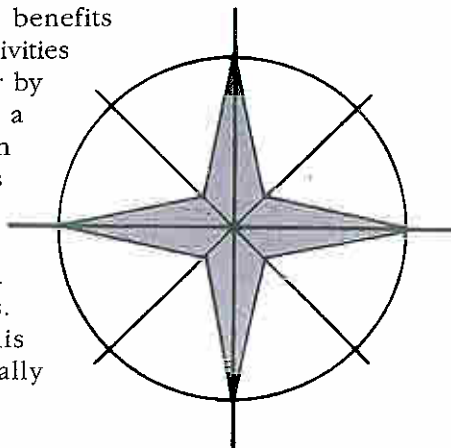
- agriculture income;
- investment income;
- real estate income;
- capital gains;
- pensions – including annuities and alimony payments; and
- other income, which includes winnings from various competitions, lotteries and gambling.

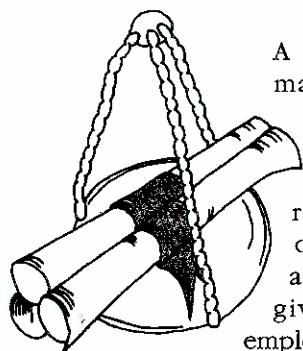
Expenses are deductible under the appropriate income category in the year in which they are incurred.

Income from employment includes all remuneration, in cash or in kind, received by a director or an employee and paid by the employer.

Income in kind is valued, whenever possible, according to official prices. Otherwise, it is valued at market prices, except for the rent-free use of a residential dwelling which is valued at 10% of that dwelling's fair market value. However, when a rent is paid by the employer, the income in kind attributed to the employee is equal to the rent paid.

Nevertheless, the lack of regulations (because certain fringe benefits may not be considered as being of taxable capacity and others are difficult to tax) lead the tax authorities to be reluctant to enforce the individual income tax rules. These rules would possibly allow the authorities to tax the private use of a car, free meals, social expenditures, benefits from recreational activities organized or paid for by the employer, a personal rebate on goods or services produced or sold by the employer, or even stock option favourable schemes. But in practice this taxation is not usually applied.





A distinction must be made between the compensation (in cash or in kind) received for the service rendered by the directors or employees, and some advantages given to them by the employer for the employer's convenience. The advantages are not considered as part of the salary and are therefore not subject to taxation.

Thus, taking into consideration the legal presumption that all benefits and advantages received by employees correspond to their compensation, it must be proved that such advantages were granted at the employer's convenience. The courts have the final word on deciding whether or not advantages are considered as salary.

Taking into consideration the rules above, it is possible to distinguish between three main groups of items.

Employment income totally subject to tax

All income received by directors or employees and not indicated below is subject to individual income tax and is deductible for corporate income tax purposes.

Fringe benefits not subject to tax

The advantages granted to the directors or employees for the employer's convenience are not taxable. Therefore, individual income tax is not levied:

- On company cars when serviced by the firm or, at least when they are assigned in the company's interest and convenience. However, if this use represents an economic value for the director or employee, they may be subject to tax. For the time being the tax authorities have not regulated the private use of company cars. Thus, in general, this economic value is not considered for tax purposes.
- Travel expenses for business purposes which may be reimbursed if they are reasonable and documented by vouchers.
- Travel subsidies for the employee's own car, which are allowed at the maximum rate of Esc49 per kilometre (1994). Other subsidies are allowed for other kinds of transport.
- A lunch allowance of up to Esc725 per day.
- Family and health subsidies paid by the social security.
- Indemnity for termination up to the limit based on one half month's salary for each year of seniority.

- Temporary dislocation allowances granted to employees if they do not exceed certain limits, as follows: Esc9,395 (or Esc8,466) inside Portugal and Esc22,542 (or Esc20,094) outside Portugal (per day 1994).
- All premiums up to 5% of the fixed salary granted to those who in the course of their work handle cash.

Fringe benefits subject to tax

Fringe benefits other than the above are or may be taxed. These include school fees, credit cards used for personal expenses, payment of holidays, interest-free loans to employees, and payment of their own domestic staff or the payment of any goods or food for the director or employee's family.

Difficulties with the valuation of fringe benefits, as well as the impracticability of taxation of certain benefits, lead to practical inactivity on the part of the tax authorities. Therefore, many benefits remain untaxed.

However, companies cannot rely on this status quo to implement their policy on fringe benefits. First, because the law already includes the majority of these benefits in the taxed world. Secondly, because the tax authorities may modify their behaviour starting with severe and additional assessments. Thirdly, because the tax courts may possibly start to improve horizontal and vertical equity submitting those fringe benefits to tax.

Stock option plans

The National Budget for 1991 created a tax incentive on stock option plans (the first time this concept is mentioned in Portuguese tax law) agreed between a company and its employees. A temporary allowance (for 1991) was attributed to the employees investing in the subscription or purchase of shares issued by their corporate employers.

For the employer, a deduction of any capital losses and expenses incurred with stock option plans was also created. Because no specific regulations were issued, the tax authorities stated afterwards such measures cannot apply to companies other than former nationalized companies. No legal provisions nor administrative rules or regulations exist stating that the difference between the official market price and the acquisition price should (or should not) be taxed as a fringe benefit.

Statements referring to the taxability of this item are slightly controversial. First, it is possible

that no particular relationship exists between this advantage and the service done. The stock option plan may be established for the employer's convenience and can also be included in a broader public policy to encourage a greater employee participation. Secondly, there are no regulations to determine the time at which the value of the shares is considered. However, in the case of taxation the general rule should be to tax the benefits at the time the option or right is exercised by the director or employee.

Thirdly, it would be possible to claim that only capital gains should be taxed and then only after realization. Gains arising from the final disposal by the employee of shares acquired under a stock option plan would attract individual income tax if the general exemption does not apply. In fact, any capital gain from disposal of shares which a resident or a non-resident individual shareholder has owned for more than 12 months is exempt from individual income tax.

Social security

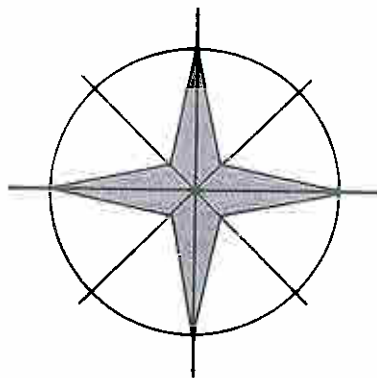
Contributory rates have remained at 35.5% of the assessment basis (in the proportion of 24.5% for the corporation and 11% for the employee) in the regime applicable since January 1 1994. Income received by members of corporate bodies (other than statutory auditors) for these services are taxed at the rate of 32% (in the proportion of 22% for the corporation and 10% for the beneficiary).

All employees and their families are covered, regardless of nationality. However, foreign employees can opt for their home regime if they are temporarily employed in Portugal and they prove they are covered in their home country.

In principle, fringe benefits not subject to tax are also not subject to social security. Nevertheless, the definition of remuneration does not coincide with the term income for individual income tax purposes.

Withholding taxes

Contributions of individual income tax and social security are deducted at source by withholding from the payroll. Receipts or any other documents showing payment or placing at the disposal of the beneficiary any remuneration earned from employment income are subject to stamp duty at the rate of 0.5%.



Corporate income tax deduction

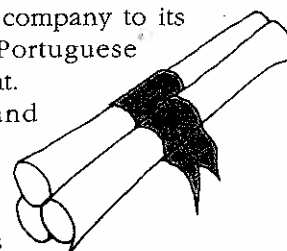
In general, the attribution of benefits in kind is accepted as a tax cost for corporate income tax purposes, because such costs are incurred exclusively and legitimately for the purpose of the business. However, some fringe benefits are limited to reasonable costs and expenses (eg vehicle running expenses, including the assurance premiums) and to their social nature and availability to employees in general (eg premium with sickness or retirement assurances and contributions made to complementary schemes of social security).

International taxation of directors and employees

The tax treatment of a manager or employee depends on whether he or she is resident or non-resident. Generally, only managers may be non-resident. In this case only the income regarded as Portuguese income is taxed at the rate of 25%. In addition, if the manager is a resident of a treaty country and satisfies the three conditions contained in the employment income article of Portugal's tax treaties, he or she may avoid taxation in Portugal.

A Portuguese resident director is taxed in Portugal for all he or she earns from activities performed in any permanent establishment abroad. Pensions paid by a foreign permanent establishment of a Portuguese company to its employees are not liable to Portuguese taxation, unless paid to a resident.

In principle, national and international mergers or divisions which change the legal structure of a company (eg a company ceases to exist as



an independent company and becomes a Portuguese permanent establishment of a foreign company or vice-versa) have no impact on the tax regime applicable to the employees. One notable exception may derive from pension schemes, but these situations must be analyzed case by case. Another exception occurs when directors become simple employees because the company has lost its own legal personality.

Finally, fringe benefits constitute one of the themes under discussion within the new Commission created to study the implementation of the Portuguese tax reform introduced in 1989. Thus, new life could soon be breathed into the Portuguese tax regime concerning fringe benefits.

