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# Portugal – challenges and opportunities of the tax system

**by Paula Rosado Pereira and Maria da Graça Martins, Sociedade Rebelo de Sousa & Associados, RL**

The Portuguese tax system presently faces a major challenge. While it is forced to cope with the State Budget's increased need of tax revenues, it tries not to compromise national economic growth and competitiveness. Therefore, some tax benefits are maintained, allowing tax efficient solutions for businesses, namely for foreign investors.



The area of tax justice is also a priority. The implementation of the tax arbitration system, recently created, is expected to contribute to a quicker resolution of the tax situations in discussion with the tax authorities.

## Financial stabilisation and tax regime

In May 2011, Portugal entered into discussions with the European Commission, the European Central Bank and the IMF in order to apply for financial support.

As a result of the negotiations, Portugal signed a Memorandum of Understanding (MoU), within the scope of the Council Regulation (EU) no. 407/2010, of May 11, 2010, which establishes a European Financial Stabilisation Mechanism.

The programme is based on three essential pillars: a fiscal adjustment to restore fiscal sustainability; structural reforms to enhance growth and competitiveness and measures to maintain the liquidity of the financial sector.

The introduction of changes in the tax system is one of the most relevant issues addressed in the agreement. In fact, the granting of the financial assistance depends on the achievement of certain measures, including tax measures aimed at increasing public revenue.

The reform programme is expected to allow the continuation of some of the existing tax regimes designed to boost potential growth, create jobs and improve competitiveness.

This assures the maintenance of some interesting features of the tax system, namely from a foreign investment


Paula Rosado Pereira


Maria da Graça Martins


Paula Rosado Pereira

Head of Tax Department

tel: +351 21 313 2033

email: paula.pereira@srslegal.pt

Maria da Graça Martins

Senior Associate

tel: +351 21 313 2019

email: graca.martins@srslegal.pt

perspective. We subsequently refer to some of these tax regimes.

## Favourable tax regime for investing in Portuguese-speaking countries

Portugal is well-positioned to act as a platform for doing business in Portuguese-speaking countries, namely Brazil, Angola, Mozambique, Cape Verde, Guinea-Bissau and East Timor. Some of these represent very interesting emerging markets.

On the one hand, there is the common language and the similarity of the legal systems, which can facilitate the process of investment in the mentioned countries. On the other hand, Portugal offers the substantial advantage of applying EU legislation, which can bring a high level of tax efficiency for the ultimate investors from other EU jurisdictions, namely with regard to dividends and interest received in connection with the investment.

The broad number of double tax treaties (DTT), covering the majority of the Portuguese-speaking countries (the negotiations for approval of the DTT with Angola are still ongoing), also constitutes an important factor to choose Portugal as a platform from which to invest in the countries in question.

In addition, the Investment Tax Code (*'Código Fiscal do Investimento'* – Decree-Law no. 249/2009, of September 23), specifically provides tax incentives for strategic internationalisation projects with a minimum investment of €250,000.

Combining such tax incentives with the specific benefits available for the Portuguese companies investing in the 'PALOPs' (*Países Africanos de Língua Oficial Portuguesa*) – African Portuguese-speaking countries, and also in East Timor – we have a tax regime with the following features:

i. a tax credit of corporate income tax between 10% and 20% of the relevant investment (creation of companies and acquisition of shares);
ii. municipal property tax, property transfer tax and stamp tax benefits; and
iii. elimination of double taxation on profits received by the Portuguese company from the PALOPs or East Timor. This elimination of double taxation is based on a participation exemption regime.

The tax regime in question is subject to the compliance of the following requirements:

i. both companies must be liable to income tax and not exempt from it;
ii. the Portuguese company must directly hold at least 25% of the share capital of the PALOP or East Timor subsidiary, and such shareholding must have been held for a time period of not less than two years; and
iii. the profits distributed must derive from profits of the subsidiary that have been previously subject to taxation at a rate of no less than 10% and cannot have origin in activities generating passive income.



## MIBC tax regime

The Madeira International Business Centre (MIBC) has a fully regulated tax regime, while being subject to EU law. It also benefits from most of the Portuguese DTTs.

Until 2020, and subject to the verification of certain substance requirements, companies licensed to operate in the MIBC can benefit from a very attractive tax rate in terms of corporate income tax (5%). There are also reduced value added tax (VAT) rates (6%, 12%, 16%, depending on the type of supply of services and goods), stamp tax exemptions and exemption from withholding tax on the distribution of dividends to non-Portuguese shareholders.

## Tax exemption on capital gains obtained by non-residents

With respect to capital gains obtained by non-resident investors, in relation to Portuguese shareholdings and securities, the Portuguese tax regime establishes a rather broad exemption.

Capital gains obtained by a non-resident entity on the sale of shares or other securities issued by Portuguese entities, or on derivatives traded in regulated stock markets, are exempt from corporate income tax in Portugal. The tax exemption in question is applicable provided that the following cumulative requirements are met:

i. the capital gains are not attributable to a permanent establishment held in Portugal;
ii. the corporate non-resident investor does not, directly or indirectly, hold any Portuguese resident entities of more than 25%;
iii. the corporate non-resident investor is not domiciled in a country, territory or region subject to a more favourable tax regime, as listed in *Portaria* (Ministerial Order) 150/2004 (Portuguese blacklist), and is not domiciled in a country, territory or region without a DTT or an international agreement on exchange of information in tax matters with Portugal; and
iv. the capital gains are not obtained from the sale of a participation held in a company whose main assets are real estate in Portugal, or from the sale of a participation in a holding company that has a *dominium* relationship with a Portuguese company whose main assets are real estate in Portugal.

## Non-habitual residents favourable tax regime

The Investment Tax Code, which includes several measures to encourage and strengthen international competitiveness, created a more favourable individual income tax regime applicable to non-habitual resident individuals.

'Non-habitual residents', for purposes of this tax regime, are taxpayers who have not been taxed in Portugal as residents in the previous five years and who have worked in scientific professions or professions of 'high added value' for an uninterrupted period of 10 years.

Income from employment or self-employment obtained by 'non-habitual residents' on 'high value added' activities of a scientific, artistic or technical character (listed in Administrative Order no. 12/2010, published on January 7, 2010) may be eligible for a 20% tax rate. Among the activities in question are those of directors and managers of Portuguese companies and legal representatives of non-resident companies in Portugal.

## Tax arbitration system

With the objective of assuring a quicker resolution of tax litigation and reducing the number of lawsuits in tax courts, Portugal established a pioneer tax arbitration system.

The regime that entered into force in the second half of 2011 allows solving, in a short period of time, various types of claims regarding tax assessments. The arbitration decision must be issued within a maximum period of six months, which can be extended for terms of two months each, for a maximum of three times.

The arbitrators are chosen from a list of professors, lawyers, tax consultants and economists, with at least 10 years of experience in the tax field. The taxpayer may also choose its own arbitrator, in which case the decision is achieved by a collective of three arbitrators.

## Impact of the European tax law at the level of direct taxation in the Portuguese tax legal framework

As a Member State of the EU, Portugal is due to comply with EU law and case law.

Some areas of Portuguese tax legislation have been under scrutiny and subject to amendment, as the result of the launching of infringement proceedings by the European Commission in the last decade.

As a result, in most cases, those areas are now in compliance with EU law and case law.

## Infringement proceedings brought against Portugal

### Pension funds

In the infringement proceeding brought against Portugal (Case No. 493/09), the European Commission considered

that the difference in treatment between the domestic pension funds (exempt from corporate income tax) and foreign pension funds (subject and not exempt from this tax) had adverse consequences both in terms of competitiveness of EU financial markets and in terms of revenue received by the investments made by pension funds.

Thus, in the view of the Commission, the relevant Portuguese tax provisions constituted a restriction on the free movement of capital, prohibited by Article 63 of the Treaty and Article 40 of the European Economic Area Agreement (EEAA).

More recently, as the proceedings continued, Advocate General (AG) Mengozzi rejected arguments presented by Portugal. The first argument relates to the need to preserve the coherence of the tax system, as the exemption from corporate income tax granted to Portuguese funds is balanced by the taxation of pensions paid by the funds to individual beneficiaries domiciled in Portugal.

A second argument put forward by Portugal has also been contradicted by the AG: the need to preserve effective fiscal supervision in Portugal, considering the EU Mutual Assistance Directive (77/779/EC) and given the difficulty of Portuguese authorities to supervise non-resident funds. The AG considered that the granting of the exemption to non-resident funds would not be an issue, since Portugal should be more concerned in the verification of the economic activities of the non-resident entity to meet the conditions for exemption in Portugal.

A decision against the Portuguese legislation is expected and will impose amendments being done to Portuguese tax provisions.

### Capital gains

The European Commission launched an infringement proceeding against Portugal regarding the scope of tax exclusion, in place on individual income tax. In fact, capital gains obtained from the sale of real estate used as the permanent abode of the taxpayer are tax exempt, provided that the value obtained with the sale is reinvested in another property to be used also as a permanent abode. The tax exclusion was then limited to reinvestment in property located in Portugal.

According to the Commission, by maintaining in force tax provisions that subordinated the benefit of the tax exclusion in question to the condition of the reinvestment being carried out through the acquisition of another property located in Portugal, Portugal failed to fulfil its obligations under Articles 18, 39, 43, and 56 paragraph 1 of EC Treaty and of Articles 28, 31 and 40 of the EEAA. The tax provisions in question were considered to be contrary to the free movement of persons and capital. The difference in treatment would have negative repercussions for the taxpayer wishing to transfer his residence away from Portugal, as the applicable tax regime could dissuade him from such transference.

### Outbound dividends paid to non-resident financial institutions

The European Commission started an infringement procedure against Portugal, in relation to certain rules of the corporate income tax code, because of the discriminatory treatment applicable to non-resident financial institutions upon distribution of dividends in Portugal.

In a statement dated July 25, 2006, the European Commission said that it is a basic rule of the internal market that Member States cannot tax companies from other Member States more heavily than their own companies. But Portugal applies a higher tax on dividends paid abroad, in comparison with the regime applicable to domestic dividends, as outbound dividends are subject to withholding tax rates ranging from 5% to 25%.

## Tax representatives

Following the infringement proceeding brought against Portugal by the European Commission, the European Court of Justice declared, in May 2011 – in case C-267/09 – the provision set forth in article 130 of the individual income tax code to be in breach of EU Law, for violation of the free movement of persons and capital. Article 130 requires non-residents to appoint a tax representative in Portugal if they receive therein any income that obliges to the filing of a tax return. Also Portuguese residents that leave the country for a period of at least six months are required to appoint a tax representative.

The Portuguese tax authorities have already stopped demanding non-Portuguese residents that are resident in countries of the EU to appoint a tax representative in Portugal. This is good news for non-residents who plan to invest in Portugal, as it results in a saving on tax representation fees/costs, which, until recently, were mandatory in certain investments.

## Amendments on the Portuguese corporate income tax code

In line with the positions taken by the European Commission, the Portuguese Budget for 2011 amended paragraph 2 of Article 95 of the corporate income tax code, now allowing the refund of tax on profits distributed by Portuguese entities to entities resident in another EU Member State, in the amount exceeding the one that would result from the application of the general Portuguese corporate income tax rate, if requested within two years.

As regards to the regime of exclusion from taxation of capital gains through reinvestment in another property to be used as a permanent abode, the regime was also extended to reinvestment in property located in another EU Member State or country of the EEA.

It is therefore evident that the Portuguese legislator has been giving significant steps towards eliminating discriminative measures at the level of taxation, thus assuring full compliance of an increasing number of tax regimes with the EU principles of free movement of persons, services and capital – as is mandatory for Member States under the EU Treaties.

This conduct of Portugal provides a better framework for the attraction of foreign investors, considering that security and legal certainty are rated among the major factors to take into account when choosing where to invest.