tax notes international
Volume 72, Number 3 ■ October 21, 2013

(C) Tax Analysts 2013. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Draft Budget Law, Corporate Reform Have Major Tax Consequences

by Francisco Cabral Matos

Reprinted from *Tax Notes Int'l*, October 21, 2013, p. 232

taxanalysts® The experts' experts.℠

COUNTRY DIGEST

(C) Tax Analysts 2013. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Draft Budget Law, Corporate Reform Have Major Tax Consequences

The Portuguese government on October 15 presented to the parliament two bills that have major implications for the Portuguese tax system: the draft State Budget Law for 2014 (SB 2014) and a corporate income tax (CIT) reform package. Unlike in the past, SB 2014 does not include amendments to the CIT Code because of the significant changes included in the proposed CIT reform.

Following is an overview of the highlights and most relevant measures included in SB 2014 and the CIT reform bill.

SB 2014: Good News or Bad News?

Personal Income Tax

SB 2014 proposes few amendments to the Personal Income Tax Code in light of the significant tax increase that took effect this year and that will be generally extended through 2014. (Prior coverage: *Tax Notes Int'l*, Nov. 5, 2012, p. 552.)

Nonetheless, SB 2014 does portend an interesting development in the taxation of residents of other EU member states. Based on case law of the European Court of Justice, individuals resident in other member states may apply for taxation on a net basis (rather than the typical withholding tax on gross income) for employment income, self-employment fees, and pensions. SB 2014 would expand that option by including any kind of income derived in Portugal.

Also, significant cuts are expected to salaries paid in the public sector and to public pensions. These measures are designed to reduce public spending but may also be seen as a hidden tax because they will reduce the net income of the affected taxpayers.

Tax Benefits Code

SB 2014 includes a generally expected benefit in connection with the reinvestment of reserves and undistributed profits. The benefit would be in the form of a dividend deduction mechanism — specifically, a tax deduction equal to the amount of reserves reinvested in specific tangible and intangible assets. The reserves would have to be reinvested within two years following the taxable period in which the undistributed profits were initially derived, and the tax credit could not exceed 25 percent of the CIT payable in a given year.

A special tax credit for investments in research and development activities would be extended for five years (up to 2020) and the carryforward period for excess tax credits would be extended from the current six tax years to eight tax years.

SB 2014 also would amend the tax treatment of investment funds. Currently, the Portuguese regime is based on taxation at the level of the investment fund and an exemption (or tax reduction) at the level of the unit holder. The proposed amendments are targeted to achieve full neutrality at the level of the investment fund and to postpone the timing of the taxable event to the time of the distributions to unit holders. However, this proposal calls for an annual tax ranging from 0.01 to 0.2 percent on the net value of the investment funds' assets.

Real estate investment funds would also be subject to increased taxation. Currently, some funds benefit from property transfer tax and municipal property tax exemptions, but SB 2014 would replace those exemptions with a 50 percent tax reduction.

SB 2014 also foresees legislation on the taxation of online gambling, which would be subject to a specific licensing/concession tax regime that has not yet been drafted.

VAT

The budget bill also proposes minor amendments to the VAT Code. In particular, it would clarify the requirements for recovering VAT in cases of bad debt and delayed invoice payments. As proposed, the VAT would be recoverable within two years from the moment the legal requirements are met. However, that period would begin on January 1 of the year after compliance with the requirements. In practice, VAT could be recoverable within three years (for example, if the conditions are met on January 15, 2014, the two-year period would start on January 1, 2015).

Energy Sector

In line with recent EU-wide developments (particularly in Spain) concerning the taxation of the energy

sector, SB 2014 proposes a special contribution on Portugal's energy market, including the gas and electricity sectors. The contribution would range from 0.425 percent to 0.85 percent and would be assessed on tangible and intangible assets (except intellectual property rights) allocated to energy production. Those entities would not be allowed to pass on this cost, nor would it be deductible for CIT purposes. This raises legal issues because a contribution of this type could change the conditions set out in the concession agreements, and the denial of a tax deduction could be in breach of constitutional provisions on corporate taxation.

CIT Reform: A Boon for the Economy

The proposed CIT reform would reduce the CIT rate from 25 percent to 23 percent, accrued with municipal and state surcharges (up to 1.5 percent and 5 percent of the taxable profits, respectively). The reform bill proposes a progressive reduction of the CIT rate, with the goal of a general rate between 17 and 19 percent as of 2016 and the elimination of municipal and state surcharges by 2018.

In addition to the corporate tax break, the reform bill contains several other significant changes, outlined below.

Participation Exemption Regime

The CIT reform would establish a worldwide participation exemption regime as opposed to the very limited regime currently in force (which basically applies to holdings in EU companies and, if specific conditions are met, to holdings in subsidiaries established in Portuguese-speaking countries).

The proposed participation exemption would apply to capital gains and to inbound and outbound dividend payments. In general terms, inbound dividends would not be subject to CIT if the following requirements are fulfilled (qualifying participation):

- the Portuguese parent company must hold at least 5 percent of the share capital or voting rights of the subsidiary;
- the participation must have been continuously held for 12 months before the distribution of the dividends;
- the subsidiary would be subject to CIT, the corporate income taxes listed in the EU parent-subsidiary directive, or an income tax similar to the Portuguese CIT with a rate no lower than 60 percent of the Portuguese CIT rate (13.8 percent for 2014); and
- the subsidiary could not be resident in a blacklisted jurisdiction, as foreseen under Portuguese law.

Outbound dividends would also be exempt from Portuguese withholding tax if the requirements described above are fulfilled by the foreign parent company. There is a slight difference, in that outbound dividends would be exempt only if the parent company is resident for tax purposes in a jurisdiction with an income tax treaty in force with Portugal.

Capital gains derived from the sale of a qualifying participation would also be eligible for a full CIT exemption.

To ensure that there is no distortion between foreign subsidiaries and foreign permanent establishments, the CIT reform bill provides for an optional tax exemption for profits attributable to a foreign PE. Because the exemption would be optional, loss-making PEs could still be eligible for worldwide consolidation with the head office. To avoid abuse, once the taxpayer elects one of the two regimes, it would remain applicable for at least three years.

Tax Losses

The carryforward of tax losses assessed as of January 1, 2014, would be extended from five to 12 tax years. The reform package also includes a specific provision on the deductibility of final losses in line with ECJ case law.

Interest Barrier Rule

This year, Portugal replaced thin capitalization provisions with an interest barrier rule. Under that rule, net interest expenditure is deductible against taxable profits only up to €3 million or 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA). A transitional period allows for a higher threshold of 60 percent of EBITDA in 2014, which is progressively reduced until it reaches 30 percent in 2017.

Bearing in mind the broadening of the participation exemption regime, the reform package proposes that the interest barrier rule should not take into account interest expenses incurred for the acquisition of a qualifying participation. To achieve that, EBITDA resulting from the taxpayer's financial statements should be amended to exclude those interest expenses.

Moreover, the alternative threshold would be reduced from the current €3 million to €1 million.

Patent Box

The CIT reform bill also proposes a new patent box regime under which only half of the income derived from the assignment or grant of a temporary right to use patents and industrial property would be subject to CIT. The patent box regime would apply only to income derived from patents and industrial property registered as of January 1, 2014.

Also, the acquisition cost of intangible assets with an undefined lifetime — namely, industrial property rights and goodwill — would be depreciated over a 20-year period.

(C) Tax Analysts 2013. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Group Relief

The reform bill would ease the eligibility requirement for the group relief regime. Currently, a minimum participation of 90 percent is required, but under the proposed amendment, the group relief regime would apply to participations representing at least 75 percent of the share capital or voting rights of the subsidiaries.

Apart from that, the reform bill emphasizes the need to reduce compliance costs and therefore would simplify the declarative obligations and other tax formalities applicable to companies under the group relief regime.

In Conclusion

All in all, SB 2014 is a minimalist legal document that essentially extends for another year most of the tax austerity measures introduced in 2013. While the public sector and the taxation of retirement pensions will be hit the hardest, the government seems to be willing to improve the economy at the corporate level, based on the CIT reform bill.

SB 2014 now is subject to discussion and final approval by the parliament, and the final version of the budget bill may include additional provisions that have a direct or indirect impact on corporations and investors. ◆

♦ *Francisco Cabral Matos, associate lawyer, Vieira de Almeida & Associados, Lisbon*

(C) Tax Analysts 2013. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.