

# Portugal – creating a competitive tax system

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**THE SIMPLIFICATION OF THE TAX SYSTEM, THE COMBAT AGAINST TAX FRAUD AND TAX EVASION, AND THE STRENGTHENING OF THE COMPETITIVENESS OF THE NATIONAL ECONOMY WERE SOME OF THE MAJOR TAX POLICY GOALS DEFINED BY THE PORTUGUESE GOVERNMENT FOR 2008.**

The internet is now seen as the main channel of interaction between tax authorities and taxpayers. In addition, an increase in the use of information and communication technologies within tax inspections has occurred. A particular focus has also been given to the fight against tax fraud/evasion and abusive tax planning, expressed in several actions taken within the last few months against some of the most relevant companies in Portugal by the District Attorney's Office and the tax authorities. Furthermore, significant developments, as a result of recent case law and amendments to the taxation applicable to entities non-resident in Portugal for tax purposes, were also introduced. Following the enactment of new and quite demanding transfer pricing rules in 2002, the possibility to request an Advanced Pricing Agreement (APA) in Portugal has also become a reality this year.

## Abusive tax planning

A special tax planning disclosure regime, similar to the one existing in the UK, has recently entered into force in Portugal (May 15, 2008), establishing declarative obligations regarding “schemes proposed or the actions adopted aiming at obtaining, exclusively or mainly, tax advantages”.

This disclosure regime foresees that tax planning schemes shall be communicated to the tax authorities by the promoter or, ultimately, by the users themselves. According to the Government, the aim of this legislation is to reinforce the effective combat of tax fraud and evasion, by adopting measures intended to allow a faster and more effective assessment by the authorities. Therefore, a careful case-by-case analysis should be made in order to assess whether a transaction will be subject to the communication,



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information or clarification duties, or not. Non-compliance with any of these duties may lead to the application of heavy penalties.

It is also important to note that in spite of the Secretary of State of Tax Affairs' efforts to bring clarification to the practical application of this regime, its interpretation is still complex and the constitutionality of certain aspects is also still not clear.

### **Public entities non-contractual liability**

After long discussions, the so-called 'non-contractual liability regime', providing for the possibility of public employees being made liable for their mistakes, has finally been enacted. Several taxpayers have already made use of this regime as a way to fight back tax authorities' abuses, filing claims against the public employees of the tax administration dealing with their matters. As a reaction to this regime, public employees argue this may cause a limitation to their independence on the decision-making process. The Ministry of Finance is presently analysing the possibility of granting some protection mechanism to these employees (e.g., professional liability insurance). This seems, however, a rather controversial issue since, ultimately, the economic burden of such mechanism would fall on the taxpayers' pockets.

### **The announced end to swaps by way of the Budget Law for 2008**

A recent (and quite concealed) change to the Portuguese Personal Income Tax Code included in the Budget Law for 2008, has dramatically changed the tax framework of most financial derivative products in Portugal. It has done so by assimilating gains deriving from interest rate swaps, foreign exchange swaps, cross-currency interest rate swaps and also those from forward exchange transactions to 'interest'. As a consequence of this change, the provisions of the majority of the double tax treaties concluded by Portugal will no longer be able to allow gains deriving from swaps to be paid without Portuguese withholding tax, as of January 1, 2008. Proper attention must, therefore, now be given to the jurisdiction where swap counterparties are resident for tax purposes to ensure that Portuguese withholding tax does not apply to such gains.

This assimilation to interest is in clear contradiction with previous administrative doctrines of the tax authorities, the expressed opinion of the OECD and the practice followed by developed countries. A new change in the law is now claimed by the market entities to re-establish the previously existing tax environment.

### **Being a non-resident, am I required to have a tax representative?**

According to Portuguese tax law, non-residents obtaining any taxable income in Portuguese territory or conducting in Portugal any type of activity that may give rise to taxable income in such territory must appoint a tax representative to comply with their tax duties.

The European Commission considered this requirement discriminatory and notified the Portuguese Government to amend this regime since it believes that this rule is contrary to the free circulation of persons and goods settled in the European Community. If the regime is not adjusted within the next few months, it is expected that Brussels shall present the case to the European Court of Justice.

### **Withholding tax on services income**

As per the provisions of the domestic tax laws, non-residents receiving income from services rendered or used in Portugal are subject to a 15% final withholding tax, provided that the payer of those services is a resident entity (subsidiary) or, being a foreign resident entity, it has a branch (or permanent establishment) in Portugal to which such payment is attributed. Transportation, communication and financial services are excluded from this regime.

Be aware that the European Commission decided to refer Portugal to the Court of Justice for its discriminatory tax rules, according to which non-resident entities providing services in Portugal are subject to a withholding tax based on the gross amount of their income, whereas domestic providers are taxed only on their net profits. The Commission considered that these rules are incompatible with the EC Treaty, which guarantees the free provision of services.

## Interest payments to financial institutions

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The withholding tax regime applicable on interest payments made to financial institutions is also under the analysis of the European Court of Justice. This is because, presently, non-resident lenders are subject to a 20% withholding tax rate levied on the gross interest paid by entities located in Portugal whereas, under the domestic legislation, Portuguese resident financial institutions benefit from a withholding tax waiver on investment income (including interest income). This amounts to say that Portuguese resident financial entities are only subject to tax on the net interest at the standard Portuguese corporate income tax rate. The European Commission has found this treatment discriminatory and, thus, contrary to the freedom to provide services and the freedom of capital, given that non-resident financial institutions may be subject to higher taxation than Portuguese-resident financial institutions.

## Transfer of funds from a permanent establishment to its head office

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The tax regime applicable to flows from permanent establishments to their head office often raises pertinent tax issues, such as those concerning withholding taxes.

A recent decision of the Portuguese Central Administrative Court – South Division (CAC-S) regarding the qualification for tax purposes of internal financing transactions between a permanent establishment and its head office in France (see Court Decision of January 29, 2008, Process no. 2161/07), has dealt with the quite relevant question of learning “what is the taxation applicable to income paid by the permanent establishment of a non-resident credit institution to its head office within the scope of an internal financing?”

This controversial question was raised before the CAC-S because the Portuguese tax authorities qualified payments made within the scope of an internal transaction as ‘interest payments’, therefore, subject to withholding tax in Portugal. When this controversial matter was referred to the CAC-S, the court decided to qualify these payments merely as internal cash flow transfers, consequently not subject to Portuguese withholding tax.

This decision is quite relevant as it upholds that payments made by a permanent establishment may not be qualified as interest income, given that a permanent establishment has no legal personality and merely carries out transactions of its head office. On the other hand, the court decided that, since the branch income taxation takes place as if it was an independent entity (i.e., in identical terms to those applicable to a resident subsidiary), charges derived from internal financing should be considered as deductible tax costs.

A more recent court decision (of June 24, 2008) has reached the same conclusions, leading to the existence of valid arguments to sustain (namely before the Portuguese courts) that payments derived from an intra-financing transaction (which should occur through the allocation of funds from the head office to a Portuguese branch) should not be subject to withholding tax in Portugal.

## Investment income obtained abroad

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The European Commission has also considered that Portuguese tax rules dealing with investment income may also give rise to discriminatory taxation.

As a general rule, under domestic tax rules, investment income derived either from national or foreign sources is subject to a final 20% Portuguese withholding tax. Nevertheless, for certain types of investment income derived from domestic or foreign sources paid by financial institutions established in Portugal, individual resident taxpayers may opt for taxation under the progressive personal income tax rates ranging from 10.5% up to 42%. This means the domestic tax rules applicable to income deriving from investments held in financial institutions established outside Portugal may be more heavily taxed than income of investments held in financial institutions resident in Portugal.

The European Court of Justice understands that these rules and measures are contrary to the principles of the European Union since they cause difficulties to foreign investors and restrict the free movement of capital and, therefore, they may be challenged before the competent courts.

## Transfer pricing Advanced Pricing Agreements

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Very relevant changes were introduced to Portuguese transfer pricing legislation in 2002, aiming to provide the tax authorities with the necessary legal tools to assure that tax revenues earned from transactions held between related parties were not reduced or displaced by taxpayers. Six years after, the possibility to enter into an APA with the Portuguese tax authorities became a reality.

The APA process comprises several phases, starting on a preliminary valuation of the terms and conditions of the agreement. The taxpayer may proceed if in a 60-day period the Portuguese tax authorities take no express decision. The next phase is to submit the proposal which must take place 180 days before the beginning of the first financial year to be covered by the agreement. Then the proposal will be assessed and, if not rejected by the tax authorities, the agreement may be concluded. Presently, the legislation provides for the possibility of having an APA covering for a period of three years.

This measure may grant, to companies having business in Portugal, a legal certainty regarding the taxes to be paid in Portugal through the previous fixation of the methods to determine the transfer prices. However, it is yet to be proved whether Portuguese tax authorities have the necessary know-how and the human resources with the adequate profile to be able to conclude APAs with the most relevant taxpayers.

## Extension of the Madeira Free Trade Zone special regime until 2020

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The Madeira Free Trade Zone (MFTZ) special taxation regime has recently been extended until 2020.

This new regime allows companies licensed to operate within the MFTZ before the year 2001, to continue to benefit from, among other exemptions, a full exemption from corporate

tax until the end of 2011, as well as from withholding taxes on dividends, royalty payments and capital duty, also ensuring that, as of 2012, those companies will fall under this new regime which shall be valid until 2020.

Companies licensed as of 2007 and until the end of 2013, will enjoy reduced corporate tax rates of 3% between 2007 and 2009, 4% between 2010 and 2012, and 5% between 2013 and 2020. These new companies, among other tax benefits, will remain totally exempt from withholding taxes on dividends and royalty payments, as well as from capital duty until 2020.

The tax benefits will depend on the jobs created per company and will be limited by a ceiling placed on the taxable base per company, which ranges from €2m (where less than three new jobs are created) to €150m (where more than 100 new jobs are created). The companies involved will have to start business within a fixed time limit, beyond which they will lose their licences. Admission to the MFTZ is also restricted to the activities included in a list drawn up by the Portuguese authorities, on the basis of the statistical classification of economic activities in the EU.

As in the previous regime applicable to companies licensed to carry out business in MFTZ between January 1, 2003 and December 31, 2006, financial and insurance intermediary activities, including ancillary activities and ‘intra-group services’ (coordination, accounting and distribution centres) are explicitly excluded. With regard to the entities already licensed in the MFTZ, the new regime is expected to be applicable from January 1, 2012, onwards.

## Conclusion

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As one may conclude from the above, keeping up with Portuguese tax legislation, doctrine and jurisprudence developments is quite a demanding job. However, as it is usual in most jurisdictions, being able to keep up and implementing a proper tax planning system will definitely provide a significant competitive advantage.