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Trends and Developments

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Following the parliamentary elections on October 5th, the last quarter of 2019 brought the opportunity both to consider a year-end balance and an outlook for the challenges ahead.

Double Tax Treaty with Angola

Keeping in mind Portugal's keen interest in playing a central role as an investment platform towards Africa – in particular, Portuguese-speaking countries – it was particularly relevant that Portugal and Angola have finally reached an agreement and executed a double tax treaty that entered into force in January 2020. The double tax treaty with Angola sets forth reduced withholding tax rates (10% for interest, 8% for dividends and royalties and 5% for service fees) but establishes close co-operation between tax authorities, promoting a more investor-friendly environment.

This is a landmark in Angola's international policy (until 2018 there were no double tax treaties in force) and raises interesting opportunities for Portuguese companies to invest in one of the biggest economies in Africa.

Real Estate Investment Trusts

The Portuguese real estate market has been very active in the past years and real estate projects are one of the main drivers of the Portuguese economy. In this context, Portugal has imported a new form of investment vehicle commonly known as "real estate investment trusts" (*Sociedades de Investimento e Gestão Imobiliária*). This regime is inspired by the Spanish "SOCIMI" framework and includes relevant tax benefits. Albeit REITs are generally subject to Corporate Income Tax (CIT) on business profits, the following items of income are excluded from the taxable profits:

- investment income (eg, dividends and interest);
- real estate income (eg, lease rents); and
- capital gains (realised from the disposal of securities, as well as real estate assets).

As a consequence, expenditure related to tax-excluded income (including management fees) is also not tax deductible against taxable profits. In addition, REITs are not subject to Municipal Surtax (up to 1.5% of the taxable profits), nor to State Surtax (up to 9% of the taxable profits). In essence, as long as REITs are focused on real estate income, they are ultimately fully exempt from any corporate taxes. In addition, profits distributed to non-resident investors (as well as capital gains from the sale of a REIT's shares) are subject to a final 10% withholding tax.

Despite being exempt from Corporate Income Tax, REITs are liable to Stamp Duty on a quarterly basis. Stamp Duty is levied at a rate of 0.0125% (per quarter) on their net asset value.

In order to benefit from the special tax regime, REITs should comply with certain requirements. In particular, real estate capital gains are exempt from CIT only in so far as real estate assets were used for rental, leasing or any other form of exploitation for at least three years prior to the sale.

Shares of REITs must also comply with the public capital dispersion requirements, including a minimum free float as follows:

- at least 20% of shares must be dispersed as of the third full year after the admission or selection for trading; and
- at least 25% of shares must be dispersed by the end of the fifth full year after the admission or selection for trading.

Lastly, REITs are subject to mandatory distribution rules (between 75% and 90% of the annual profits, depending on the type of investments realised).

Anti-Tax Avoidance Directive

In May 2019, Portugal enacted the first legislative package implementing Directive (EU) 2016/1164 of 12 July 2016, amended by Directive (EU) 2017/952 of 29 May 2017 ("ATAD 1" and "ATAD 2", respectively).

Back in 2014, Portugal designed and implemented a relevant Corporate Income Tax reform, which already considered the international trends that were later consolidated under the BEPS Action Plans. In light thereof, the changes implemented in 2019 were mainly focused on fine-tuning the relevant provisions, rather than enacting brand new rules. The most relevant amendments referred to the interest deductibility barrier rules, the general anti-avoidance rule (GAAR), the controlled foreign corporations (CFC) rule and exit tax rules.

The Portuguese GAAR was reviewed and now has a wider concept of "tax abuse", focused on business-like arrangements and inspired by the principal purpose test. The wording of the existing GAAR was adjusted to set forth that a structure may be considered abusive if only one of the main purposes of the arrangement is to get a tax advantage, as compared to the previous wording that required the arrangement to be wholly or mostly aimed towards obtaining a tax advantage. This firm takes the view that this amendment will have a material impact in the Portuguese tax system. On the one hand, it should be noted that Portuguese tax authorities have resorted to the GAAR mostly to tackle transactions carried out by natural persons, mainly in the context of Personal Income Tax, Stamp Duty (gift tax) and Property Taxes. The fact that the wording of the GAAR is now based in a business purpose reasoning and on the assessment of the commercial/economic grounds of the relevant transactions will partially jeopardise the systematic approach of previous tax court decisions that were not always focused on finding an economically sound reasoning, but conversely on understanding if the tax motivation was the leading one. On the other hand, having the wording of the domestic GAAR adjusted to ATAD will likely limit the discretion of Portuguese courts to interpret said provision, as the case law of the European Court of Justice will necessarily provide the framework for said interpretation. As a result, this firm anticipates increasing litigation based on the GAAR under the new wording.

The existing Portuguese CFC rule provided that an entity is considered to be subject to a more favourable tax regime if the *nominal* tax rate applicable in the foreign jurisdiction were lower than 60% of the nominal tax rate applicable under the Portuguese Corporate Income Tax Code. Said regime has been reviewed and now sets forth that CFC rules apply on an effective tax basis, rather than on a nominal tax basis. Hence, an entity is now considered to be subject to a clearly more favourable tax regime if the corporate tax effectively paid abroad is lower than 50% of the tax that would otherwise be due if said entity was resident in Portugal for tax purposes. This amendment results in a more complex provision, mostly as the comparability analysis between the taxation applicable abroad and the one that would apply in Portugal will increase tax compliance and will require a daily-basis verification as to whether a Portuguese Corporate Income Tax return would be due. This will dramatically change the applicability of the Portuguese rule, which will no longer apply residually as a purely anti-abusive provision and will most likely become part of the "standard application" of Corporate Income Tax in Portugal. There is as yet no guidance from the Portuguese tax authorities on how the new CFC rule should be monitored and applied in practice by Portuguese companies.

Whereas in the previous version the CFC rule would not apply if the foreign companies were engaged solely in international (non-Portuguese) activities, the current wording included a material change in the scope of application of the Portuguese CFC rule by deleting said carve-out rule. It follows that, as from 2019, the taxable profits of a Portuguese company may include the (undistributed) profits of a foreign company, even if the latter company does not operate, nor by any means deal with Portuguese entities. In broad strokes, the triggering event will be holding a qualifying stake (≥ 25%) and an effective tax rate lower than 10.5%.

Furthermore, this firm takes the view that the moment of the adoption of ATAD would have been a good opportunity to set forth a general carve-out for the CFC rule based on "economic substance". This carve-out is currently limited to entities resident within the EU and EEA (subject to administrative co-operation). The fact that the carve-out is not applicable to third countries may support taxpayers challenging the application of the CFC rule when the foreign company is in a non-EU or EEA country.

The existing interest limitation rule was amended to accommodate a wider definition of borrowing costs that contribute to determining taxable profit or tax loss, as the existing legal regime is already in accordance with that set forth in ATAD. This may imply a material impact on companies resorting to derivative financial instruments that are now covered by the interest limitation rule. The impact of the new wording on real estate projects should also be underlined. Up until 2019, capitalised interest (ie, interest accrued in the context of the financing of construction projects) was not considered for the assessment of the tax deduction limitation. The new wording has now encompassed that in the scope of the provision.

The coming into force of this amendment in the middle course of a taxable period raises some temporal application challenges. In this regard, the Portuguese tax authorities have issued official public guidance taking the view that the new rules will apply to FY2019, notwithstanding that they were enacted only in May 2019.

Outlook for 2020

Given the recent elections, the State Budget – which is usually approved before 31 December each year – is still being discussed in Parliament and is expected to enter into force by 1 March 2020. The draft State Budget includes minor changes in the Portuguese tax system. We highlight a relevant amendment to the Stamp Duty Code that will positively impact intra-group financing (in particular, cash pooling arrangements and the upstreaming of funds from Portuguese subsidiaries to its parent companies), the extension of the Patent Box regime to the licensing of software and the creation of new contributions in the health sector (eg, a special contribution of medical devices). Windfarms are also expected to be under the spotlight as a result of a technical amendment to Municipal Property Tax (IMI). Apart from the relatively few changes proposed in the State Budget for 2020, next year will be challenging from a tax standpoint, in light of the new rules in force under Mandatory Disclosure Directive (DAC 6) and ATAD.

Such changes are expected to imply a general increase of tax compliance costs and also to raise technical changes on the interpretation and application of the new rules. Further changes to the tax legislation are also expected in respect of cross-border structures, as the implementation of anti-hybrid mismatch arrangement rules (under ATAD 1 and ATAD 2) was postponed for 2020. Portugal does not have any anti-hybrid rules (except for the adoption of the specific rule foreseen in the Parent-Subsidiary Directive), thus there are several key decisions to be made by the Portuguese government that require in-depth analysis and will have significant impacts in the Portuguese tax system as a whole.

Notwithstanding the challenges ahead, Portugal is attracting the attention of multiple investors – private equity funds, real estate investors, multinationals – but also of entrepreneurs and highly qualified individuals. In this regard, since 2010 the Non-Habitual Tax Resident's regime has been actively promoting the relocation of non-resident individuals, looking for quality living combined with a favourable tax regime that entails a full tax exemption on certain types of foreign-source income (such as dividends, interest, rents and in some cases salaries) and a flat 20% income tax rate on Portuguese salaries and professional fees for *high value added activities*. Recent improvements in this regime are likely to promote the relocation of even more highly qualified professionals during the course of 2020.

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