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Corporate Tax 2022

Portugal: Trends & Developments

Tiago Marreiros Moreira, João Riscado Rapoula
and Ana Azevedo Pinto
VdA

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Trends and Developments

Contributed by:
Tiago Marreiros Moreira, João Riscado Rapoula and Ana Azevedo Pinto
VdA ***see p.9***

Introduction

Around the world, changes in tax policy during 2021 still reflected the global impact of the health crisis caused by the COVID-19 pandemic. In Portugal, the State Budget Proposal for 2022 has been voted down, which led to the dissolution of the Portuguese Parliament, and the future remains uncertain with regard to the tax policy applicable in 2022. However, the fact that Portuguese voters have re-elected the former government party with a majority in the Parliament seems to indicate political stability and the likelihood of the approval of the State Budget for 2022 that was previously rejected.

Remote Working – Tax Impacts Arising from the New Settings of Employment Relationships

Before COVID-19, remote working was an unattainable goal for some employees and seen as a business disruption by employers. However, the pandemic has forced governments to restrict travel, preventing many employees from performing their activities in their country of employment and forcing employers to swiftly adapt to the new reality and implement flexible work policies.

Permanent Establishment Risks

Now, the possibility of remote working is seen as valuable by employees, because it improves their work-life balance, and is a pivotal and differentiating factor when choosing where to work. Therefore, employers are becoming more flexible, accommodating employees' preferences to work remotely, which requires a thorough evaluation of the tax risks that may arise with the "new normal", notably in terms of permanent establishment (PE) risks.

Under the Corporate Income Tax Code (the "CIT Code"), a foreign company would be deemed to have a PE in Portuguese territory if:

- it has a fixed place of business (such as premises, facilities or installations) through which it carries out an economic activity in Portugal – a physical PE;
- there is a building site, construction or installation project taking place in Portuguese territory – a project PE;
- there is a person who is acting in Portuguese territory on behalf of the non-resident entity and they play the principal role leading to the conclusion of contracts that are routinely concluded, even though, from a formal standpoint, they might not have the powers to formally conclude said contracts – an agency PE; or
- it provides services in Portuguese territory for more than 183 days over a 12-month period, either directly (through employees) or indirectly (through service providers) – a services PE.

The application of Portuguese legislation is limited by the provisions of an applicable double tax treaty (DTT), which prevails over domestic law. Therefore, as the majority of the DTTs to which Portugal is a signatory follow the previous OECD standard and are not aligned with the current wording of the OECD Model Tax Convention on Income and on Capital, there are practical issues regarding the application of Portuguese law.

The Portuguese Tax and Customs Authority (PTA) remains silent, even though remote working already has a wide use and should continue to increase in the post-COVID-19 era. Despite the absence of guidance from the PTA regarding the tax impacts arising from remote working and its likelihood of triggering a Portuguese PE, and without legal amendments that accommodate this new reality, it is essential to address this topic.

In particular, the authors take the view that the mere fact that the employee is working remotely from Portugal is not sufficient to trigger a PE in Portugal. In other words, if the employee keeps the exact same functions and the sole link to Portugal is their physical presence, the employer should not have a Portuguese PE, provided that it is only responding to a personal choice of the employee, who has decided, or has no other option but, to work remotely.

On the contrary, the circumstance of having an employee working remotely in Portugal could indeed trigger a PE to the extent that the activity of the employee would correspond to the core business of the employer, the activity of the employer would be oriented to the Portuguese jurisdiction and the employee's day-to-day functions would be pivotal to develop the business plan and attain the objectives of the company in Portugal, or the employee was required, by the employer, to work remotely from Portugal.

In 2022, it is important for the Portuguese legislator to amend tax law to specifically address remote working situations in order to keep pace with the change in business and technology.

Home Offices

At the end of 2021, Law No 83/2021, of December 6th ("Law 83/2021"), was approved, amending the legal regime applicable to remote working.

Under Law 83/2021, employers are required to provide employees with compensation related to the additional expenses incurred through remote working; such as the acquisition of equipment necessary to perform the employees' activities, an increment of costs relating to energy and the internet, as well as costs concerning the maintenance of employees' equipment.

From a tax perspective, such compensation related to the additional expenses incurred because of remote working will not be deemed, at the level of the employee, as taxable income and, at the level of the employer entity, will be considered as a deductible expense for corporate income tax purposes.

However, the employee would have to demonstrate an increase in the expenses by comparing the values incurred in the given tax year with those pertaining to the previous year.

The regime of Law 83/2021 is therefore quite burdensome because it requires employees to keep track of all the expenses related to utilities and equipment, and employers to request documentation to support the amounts that will be paid, which will benefit from the exemption from payroll taxes. Moreover, it is a very unambitious set of rules as it departs from a mere increase of expenses when it should consider home working as the new normal and therefore compensate the employee not by establishing a parallel between the level of expenses before home offices became the rule but rather allow for a design of a salary package that considers utilities and the purchase and maintenance of equipment as true professional expenses.

Therefore, from a tax perspective, a fairer solution would be to set forth that employers may "co-finance" the expenses related to, for example, electricity and the internet and the purchase and repairments of office equipment, given that

these expenses are instrumental for the performance of the professional activity, by defining a maximum monthly amount under which no personal income tax (PIT) or social security contributions would apply. Conversely, any amounts above that predefined threshold payable to employees would be subject to PIT and social security. With regard to, for instance, business trips made by employees, a predefined amount below which no tax and social security contributions would apply is already a criterion in use to compensate employees for such trips. Under the current regime of business trips, it is not necessary to have an exact correlation between expenses incurred by the employee and the amount granted to them by the employer, precisely because the threshold defined by the Portuguese legislator allows the exclusion of these payments as employment income.

Such a solution is not particularly demanding as it does not require the employee to demonstrate any expenses and a similar solution could be adopted for compensating employees for home office work.

Unfortunately, the current regime constitutes a significant challenge for taxpayers as it might lead to legal uncertainty and to an increase of tax litigation in this regard, given that the administrative burden will require companies and employees to demonstrate that the expense to be compensated should indeed be exempt from PIT and social security contributions.

ATAD 3 – a Boost to the Market of Regulated Financial Entities?

On 22 December 2021, the EU Commission released a proposal for a directive to prevent the misuse of shell entities for tax purposes and to amend the Directive on administrative cooperation in the field of taxation (DAC) – commonly designated as the "Unshell Directive" or "ATAD 3" (which is expected to be applicable as from 1 January 2024, with its implementation beginning in 2023).

In a nutshell, ATAD 3 aims at preventing tax avoidance and evasion practices linked to the use of entities that do not have any, or have only minimal, substance. Only entities that are deemed to have a high risk of having a low economic substance are subject to reporting obligations under ATAD 3 and subsequent scrutiny by the PTA. An entity is considered as a high-risk entity if the following cumulative requirements are met:

- 75% of its income is derived from passive income (notably, interest, royalties and dividends);
- the entity mainly engages in cross-border activities or passes revenues to foreign shareholders; and
- the entity outsources daily management and decision-making for significant functions.

High-risk entities will be required to declare in their annual tax returns if the requirements of minimum substance regarding premises, EU bank accounts and exclusive local directors dedicated to the group of companies or full-time local employees are met.

If the requirements are not met, entities will be deemed not to have minimal substance for tax purposes and will be prevented from requesting a certificate of tax residence for use outside the jurisdiction of tax residence and accessing benefits established in EU directives and DTTs.

Notwithstanding the above, EU member states shall ensure that listed companies, regulated financial entities, holding companies that are resident for tax purposes in the same EU member state as their shareholders or the ultimate parent entity, and entities that have at least five

full-time employees involved in operations are not subject to ATAD 3.

While ATAD 3 is yet to be implemented by EU member states, it is expected that multinational groups of companies will promote substance assessments in order to anticipate potential impacts arising from the implementation of the new rules and avoid the reputational risks arising from making a declaration of having a high risk of having a low economic substance.

Taking into account that regulated financial entities are excluded from the scope of ATAD 3, and have low maintenance costs, it is also expected that the Portuguese market for investment funds may benefit from this new set of rules.

Withholding Tax Applicable to Dividends Obtained in Portugal by Non-EU Investment Funds

Under Portuguese law, dividends distributed by Portuguese companies to resident investment funds are not subject to withholding tax (WHT). However, if dividends are distributed to non-resident investment funds, a 25% WHT rate will be applicable (a reduced WHT rate may be applied pursuant to a DTT, provided that the non-resident investment fund is eligible to claim DTT benefits).

The described difference in treatment between resident and non-resident investment funds has been seen as incompatible with EU law – namely, a breach of the free movement of capital – and tax litigation in this regard has increased in Portugal, with several cases being brought before the Portuguese tax courts by foreign investment funds, claiming for the application of a full exemption and a WHT refund. For the purposes of claiming WHT refunds, taxpayers should file an administrative claim (which is the mandatory first step) within two years from the legal deadline to deliver the WHT to the PTA.

One of these cases has reached the European Court of Justice (ECJ) and a decision was issued in mid-March 2022, confirming that there is a breach that renders Portuguese domestic WHT provisions incompatible with the free movement of capital.

The decision will have a direct impact on several cases pending the ECJ's position in this leading case and paves the way for the elimination of WHT on dividends received by collective investment undertakings throughout Europe.

In light of the above, relevant amendments to the Portuguese legislation are expected in 2022, with the purposes of tackling this discriminatory treatment and increasing the legal certainty for non-resident investment funds investing in Portuguese companies.

DAC6 – Overview of Reported Mechanisms and Legal Privilege

Portugal has adopted Council Directive (EU) 2018/822, of 25 May 2018 (DAC6), which sets forth mandatory disclosure rules regarding certain cross-border tax mechanisms that meet at least one of the specified hallmarks.

Due to the COVID-19 pandemic, Portugal postponed for six months the reporting obligations set forth in DAC6 and the first reports took place at the beginning of 2021. Portugal also delayed the approval of the official reporting forms and the publishing of the official guidelines issued by the PTA on the matter.

In the transposition process, Portugal decided to extend the territorial reach of DAC6 to purely domestic transactions, as well as the scope of the reporting obligations to value added tax, and adopted a peculiar position as regards professional privilege, setting forth the exact same rules for intermediaries covered (or not) by legal or contractual privilege.

In December 2021, the PTA published a debriefing note regarding the mechanisms that had been reported under DAC6 since its entry into force in Portugal and until 31 October 2021. According to the document, the majority of the 119 reported mechanisms were reported directly by the relevant taxpayers, had a cross-border nature and related to the following hallmarks:

- the conversion of income into capital, gifts or other categories of revenue that are taxed at a lower level or exempt from tax;
- deductible cross-border payments made between associated enterprises when the payment benefits from a full exemption or from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes; and
- a cross-border transfer of functions and/or risks and/or an asset with a variation of more than 50% of the EBIT.

The PTA has also published three examples of reported mechanisms, including:

- a donation of shares and their subsequent sale, stepping up their acquisition price, for the purposes of assessing the taxable gain;
- an increase of share capital followed by a reduction to distribute profits; and
- the conversion of dividends into debt to the shareholder.

Despite the list of examples and the information on the transactions reported, a year has gone by and the guidelines issued by the PTA in January 2021 remain unchanged, preventing taxpayers and intermediaries from having additional clarifications regarding the application of DAC6, which is crucial, given the wide scope of the hallmarks and the potential impact on all taxpayers and intermediaries in terms of compliance costs.

With regard to the reporting obligations applicable to intermediaries with legal privilege (such as lawyers), the Portuguese Ombudsman has considered that the Portuguese transposition of DAC6 breaches legal professional privilege under Portuguese law and has requested the Constitutional Court to declare that this set of rules is in breach of the Portuguese Constitution. It is expected that the Constitutional Court's decision regarding this regime will be known in 2022.

The Danish Cases and the (Re)design of Financing of Portuguese Companies

In February 2019, the ECJ issued ground-breaking decisions in six cases that dealt with the interpretation of the Parent-Subsidiary Directive and the Interest and Royalties Directive, relating to beneficial ownership and tax avoidance (the "Danish Cases"), regarding the exemption from WHT when dividends and interest payments were made from a Danish company to a company resident in an EU member state, which passed on the payments to an ultimate parent company residing in a third country, which would not have access to the Directives' benefits.

In the Danish Cases, aside from broadening the definition of tax avoidance, the ECJ also clarified that the term "beneficial owner", under the Interest and Royalties Directive, should be interpreted as the entity that benefits economically from interest received and has the power to freely determine the use of interest.

In Portugal, the PTA has reinforced tax inspections regarding the application of WHT obligations under the aforementioned directives, departing from the stricter interpretation of beneficial ownership provided by the Danish Cases, which is not aligned with Portuguese domestic law.

This approach from the PTA may lead companies to assess alternative funding arrangements, such as the one described below.

Under Decree-Law No 193/2005, of June 7th ("DL 193/2005"), investment income (including interest) and capital gains arising from bonds are exempt from tax in Portugal provided the bondholders qualify as non-Portuguese residents without a PE in Portugal to which such income is attributable.

To benefit from the WHT exemption, the bonds shall be integrated in:

- a centralised system for securities managed by an entity resident for tax purposes in Portugal; or
- an international clearing system operated by a managing entity established in an EU member state other than Portugal or in a European Economic Area member state, provided, in this case, that such state is bound to co-operate with Portugal under an administrative co-operation arrangement in tax matters similar to the exchange of information schemes in relation to tax matters existing within the EU member states; or
- other centralised systems not covered above, provided that, in this case, the Portuguese government authorises the application of DL 193/2005.

In addition, the beneficiaries shall be:

- central banks or governmental agencies;
- international bodies recognised by the Portuguese state;
- entities resident in countries or jurisdictions with which Portugal has a DTT or a tax information exchange agreement in force; or
- other entities without headquarters, domicile, effective management or a PE in Portuguese territory to which the relevant income is attributable and that are not domiciled in a blacklisted jurisdiction.

Taking into account the current interpretation from the PTA regarding beneficial ownership, some multinational groups may wish to revisit the way they finance their activities and opt for being financed through the issuance of bonds, under DL 193/2005, rather than turning to intragroup financing. Therefore, 2022 may be a year of significant changes with regard to the financing of Portuguese companies.

Outlook for 2022

In 2022, Portugal will start implementing its Recovery and Resilience Plan (RRP), which consists of 83 investments and 32 reforms, with the aim of preparing Portugal for the challenges and opportunities arising from green and digital transitions. The RRP will be supported by EUR13.9 billion in grants and EUR2.7 billion in loans, and it is expected to lift Portugal's gross domestic product by 1.5% to 2.4% by 2026 (Portugal's Recovery and Resilience Plan, European Commission).

With the election of a new majority government, it is expected that 2022 and the next four years will be stable from a political standpoint, which is crucial to promote an investor-friendly environment, to increase economic growth and to implement tax reforms.

As mentioned previously, the re-election of the former government party with a majority in the Parliament seems to indicate the approval of the State Budget for 2022 that was previously rejected by the Parliament, which sets forth a reduced set of amendments to the CIT Code. The extinction of the special payment on account, the revision of the patent box regime, promoting the competitiveness of the Portuguese regime compared to other EU member states and the Tax Incentive to Recovery are proposals that

are worth highlighting, given their relevance to attracting foreign investment and to helping Portuguese companies recover from the negative impacts arising from the COVID-19 pandemic.

Moreover, with another budget law to be proposed in October (to stimulate the economy in 2023), the taxation of cryptocurrency assets – which, up until now, has been outside the scope of the expected amendments in tax law – may be brought to the agenda. 2022 should therefore be a year with several amendments to Portuguese domestic tax law.

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AUTHORS

Tiago Marreiros Moreira is the executive partner of the Social & Corporate Advisory Group and head of the Tax practice, having joined VdA in 2001. He regularly advises domestic and international companies with regard to tax law, in sectors such as financial, energy, pharmaceutical, communications, real estate and services. Tiago is also VdA's head of international operations. He represents clients in the financing, acquisition and restructuring of cross-sector national and multinational groups and companies. Tiago plays a key role in the tax definition of transfer pricing policies for multinationals as well as in the negotiation and settlement of disputes with tax authorities and in the implementation of financial operations. Tiago is also very active within private wealth.

João Riscado Rapoula is a managing associate of the Tax practice area, where he has been involved in several corporate transactions, namely in international tax structuring and tax litigation, as well as in EU law and social security matters. João, who joined VdA in 2007, is admitted to the Portuguese Bar Association and has consolidated his position as one of the leading lawyers at VdA in corporate tax law, in particular in corporate reorganisations.

Contributed by: *Tiago Marreiros Moreira, João Riscado Rapoula and Ana Azevedo Pinto,* ***VdA***

Ana Azevedo Pinto is an associate in the Tax practice who devotes most of her practice to private wealth transactions and private client planning, advising family offices and domestic and international clients in the legal and tax structuring of their investments and estates, and regarding relocation to Portugal and succession planning. Ana, who joined VdA in 2019, has also been involved in tax disputes before judicial and arbitral courts, and provides regular tax advice to national and international clients on a wide range of taxes.

VdA

Rua Dom Luís I, 28
1200 – 151
Lisboa
Portugal

Tel: +351 21 311 34 92
Email: TM@vda.pt
Web: www.vda.pt