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A: Group approach and separate entity approach in domestic and international tax law

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Summary and conclusions

Tax systems, including that of Portugal, were generally designed and prepared to address a separate entity taxation. Due to numerous factors, such as globalization and the increase in the complexity of business models, most companies are currently organized and carry out their activities as a group.

In Portugal, there is not a standard definition of a group of companies for accounting, corporate or tax purposes. Even from a tax perspective, the definition of a tax group depends on the nature of the taxation under analysis.

In fact, the Portuguese tax law only provides for a detailed special regime to address the corporate income taxation of a group of companies, which is not based on a typical tax consolidation model, being instead a mere tax aggregation by summing-up of each company's individual tax result to obtain the group's aggregate tax result, with specific adjustments and exceptions and allowing under certain conditions the offset of profits and losses recorded at the level of the group and exempting from withholding corporate taxation intra-group income payments.

It should be noted that even though each company within a group's perimeter should prepare and submit its individual IRC return, the aggregated taxable profit or loss is computed and assessed by the so-called dominant company corresponding to the algebraic sum of the taxable profits (losses) individually assessed by each company of the group. Furthermore, municipal and state surcharges are individually assessed and levied over the taxable profit of each entity of the group.

In this context, we can conclude that even in a group context the separate entity taxation principle is still relevant under the Portuguese IRC regime.

Furthermore, as a consequence of the IRC legal reform made in 2014, the Portuguese tax group regime was adapted to the ECJ case law, namely, to enable a non-resident company to be considered as a dominant company of a Portuguese tax group. Additionally, the Portuguese IRC framework has been recently amended in order to introduce in the Portuguese tax system the OECD guidelines as well as the ATAD.

Considering the above, this report aims to analyze in further detail how the Portuguese tax system deals with the separate entity taxation approach and the group approach both in domestic and in cross-border transactions.

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Part One: Separate entity approach and group approach in domestic law

1.1. General overview

The basis of the current Portuguese corporate tax system was designed in 1989 when income taxes both for legal entities (*Imposto sobre o Rendimento das Pessoas Coletivas* – IRC) and individuals (*Imposto sobre o Rendimento das Pessoas Singulares* – IRS) were introduced for the first time in Portugal.

Historically, legal entities are taxed separately from their shareholders, thus avoiding the deferral of the payment of taxes at the level of the latter, that otherwise would exist whether businesses were not taxed in case no dividend or reserves were distributed, giving rise to deep inequality in the taxation of legal entities and individuals. Furthermore, considering that legal entities are required to comply with accounting obligations, the assessment and collection of IRC at their level is generally efficient and allows for cross-checking control between taxpayers. Besides, the separate entity taxation is also a reflection of the functional and property autonomy of legal entities which, in most cases, have legal personality and capacity as individuals.

Generally, Portuguese IRC is levied on worldwide income obtained by Portuguese tax-resident legal entities as well as on profits attributable to a Portuguese permanent establishment (PE) of a non-resident entity and on Portuguese sourced income obtained by non-resident entities with no PE in the Portuguese territory.

Under an accounting partial dependency model, the Portuguese IRC regime provides for an assessment of an entity's taxable profit or loss based on the net accounting result, as disclosed in the financial statements under Portuguese generally accepted accounting principles (based on the International Financial Reporting Standards and International Accounting Standards), adjusted under specific IRC rules.

The Portuguese IRC Code also provides for a tax transparency regime to address, *inter alia*, situations where the separation between the legal entity and its shareholders is very fragile. Under such regime, the taxable amount of the transparent companies (assessed according to the IRC rules) is considered as taxable income of their shareholders, in the proportion of their participations and regardless of actual distribution of dividends, being taxed at the level of the latter.

If the shareholders covered by the tax transparency regime are non-residents, the income attributed to them is deemed to be obtained through a PE located in the Portuguese territory.

As noted by the existing doctrine and jurisprudence, the Portuguese tax transparency regime is intended to achieve tax neutrality, avoid economic double taxation and prevent tax evasion in cases where the set-up of a company would function as a tax shelter.

Briefly, the tax transparency regime applies to civil companies not incorporated under a corporate form, professional services firms, asset management companies, complementary business groups, which are established and operating in accordance with the applicable law and European Economic Interest Groupings, and treated as residents.

Even though transparent entities are not responsible for the payment of the IRC due (the corresponding income taxation falls on their shareholders), they are liable for the payment

of IRC autonomous taxation[5] and are still qualified as taxable entities for IRC purposes. In fact, transparent entities are required to comply with ancillary obligations (e.g., keeping accounts, submission of the IRC annual return) and the doctrine also considers that they are entitled to pursue legal actions by themselves in order to claim, e.g., the tax assessed at their level and allocated to their shareholders.

1.2. General system of inter-company transactions outside special group taxation regimes

As a rule, income distributed and/or paid by companies to their shareholders – essentially those related to the main financial flows derived from dividends, capital gains and interest – is taxed at the level of the latter regardless of their nature (corporate shareholders or individual shareholders).

Generally, dividends and interest paid to individual shareholders in a purely domestic context are taxed through a final withholding tax at a 28% flat rate. Nonetheless, individual shareholders may elect aggregating such income and, in the specific case of dividends, only 50% of the amount may be taxed, basically with the aim to mitigate economic double taxation. When such option is chosen by the beneficiary, it is mandatory to aggregate all income included in the same IRS category, being that income taxed under the general and progressive IRS rates. In this scenario, the withholding tax assumes the nature of payment on account for the final tax due.

In their turn, capital gains obtained by resident individual shareholders arising from the disposal of shares are taxed at an autonomous flat rate of 28% also with the option to elect to aggregate such income under the same conditions described above. In this regard, it should be noted that capital gains derived from the sale of shares of micro and small enterprises as defined by Portuguese Decree-Law not listed on regulated or unregulated stock exchange markets are only considered in 50% of their amount.

With regard to the corporate shareholders, dividends obtained are, in principle, subject to a withholding taxation at a 25% flat rate with the nature of a payment on account of the final tax due.

In contrast, capital gains derived from the disposal of shares are taxed at the level of the corporate shareholders at the standard IRC rate.[6]

Nevertheless, with the aim to avoid economic double taxation, since the IRC reform occurred in 2014, Portuguese IRC Code has provided for a universal domestic participation exemption regime under which inbound dividends and capital gains may be exempt from IRC whenever a set of conditions are cumulatively met, namely:

– The Portuguese shareholder holds (directly or indirectly) a minimum of 10% of the share capital or voting rights of the distributing company;

[5] IRC autonomous taxation is aimed to penalize certain expenses (e.g., undocumented expenses, certain expenses incurred with private or commercial vehicles) with a nature that may lead to tax evasion.

[6] The current standard IRC rate is 21%. For small and medium enterprises which carry out directly and as their main activity an economic activity of agricultural, commercial or industrial nature, a reduced IRC rate of 17% is applicable on the first EUR 25,000 of taxable income, with the surplus taxed at the standard IRC rate of 21%. A municipal surcharge of up to 1.5% and state surcharge may also apply.

– Such participation is held uninterruptedly during the year preceding the distribution of dividends or the sale of the participations (or, in the case of dividends, if held for less time, it is maintained for the necessary time to complete that period);
– The Portuguese shareholder is not covered by the tax transparency regime;
– The distributing company is subject to and not exempt from IRC or a tax provided in the Parent-Subsidiary Directive[7] or a similar tax which tax rate is not less than 12.6% (i.e., 60% of Portuguese IRC rate of 21%); and
– The distributing company is not resident in a blacklisted jurisdiction as considered by Portuguese tax law.

In order to avoid deduction with no inclusion schemes[8] derived from mismatches on qualification, the participation exemption regime does not apply to dividends considered as tax-deductible expenses at the level of the distributing company.

Also, this regime does not apply to capital gains derived from the sale of share capital if the immovable property of the participated company represents directly or indirectly more than 50% of its asset, with the exception of the immovable property allocated to an agricultural, industrial or commercial activity which does not consist in the purchase and sale of immovable property.

Furthermore, the Portuguese IRC Code provides for an anti-avoidance provision under which the participation exemption regime shall not apply to profits distributed when there is a construction or series of constructions which have been carried out for the main purpose, or one of the main purposes, of obtaining a tax advantage which frustrates the object and purpose of eliminating the double taxation on such income, or which is not considered genuine, taking into account all relevant facts and circumstances. To this effect, a construction (or series of constructions) should not be considered as genuine if it does not have valid economic reasons and does not reflect an economic substance.

When the domestic participation exemption regime applies, and the shareholder company held the participation in the share capital of the distributing company uninterruptedly during the year preceding the distribution of dividends, the withholding taxation does not apply.

Moreover, interest obtained at the level of the corporate shareholders is generally taxed through the withholding tax at a flat rate of 25% as payment on account for the final tax due. Withholding tax may not apply for interest and other income resulting from contracts of shareholder's financing, commercial paper or bonds, where the corporate shareholder holds, directly, or indirectly through other companies in which it is dominant, more than 10% of the share capital with voting rights of the debtor company, provided that the participation in the share capital has been held by the corporate shareholder on an uninterrupted basis during the year preceding the date in which the income is made available.

Besides, as a rule, market value interest charges made by the corporate shareholder to a Portuguese subsidiary within intra-group loans are allowed as tax-deductible costs.

Note that the Portuguese IRC Code also imposes a shareholders' loan maximum interest rate corresponding to Euribor 12 month plus a 2% spread (6% spread in the case of medium-

[7] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states.

[8] I.e., situations where payments are tax deductible at the level of the payer and are not included in the ordinary income of the recipient.

sized enterprises), above which its tax deductibility will be denied except when a higher interest rate can be justified under transfer pricing rules.

The Portuguese transfer pricing regime only applies to transactions made between related parties, which means that inter-company transactions between independent parties are not legally required, for IRC purposes, to observe the arm's length principle.

1.3. Group taxation regimes

Portuguese corporate law is based on the concept of affiliated company, but it does not provide for a definition of such concept, pointing out the kind of affiliation relationships between companies, namely the relationships of simple participation, mutual participation, control and group.

A relationship of simple participation exists whenever a company holds at least 10% of the share capital of another. A relationship of mutual participation exists when two companies hold each, at least, 10% of the capital of the other. On the other hand, a relationship of control exists when one company is able to exercise directly or indirectly a dominating influence over another; this dominating influence is presumed to exist when the former company holds the majority of capital, the majority of the voting rights, or the right to nominate the majority of the members of management or supervisory organs of the latter.

Portuguese corporate law does not provide a standard definition of group of companies but provides three types of specific instruments for its creation and organization, namely the full domination, the contract of parity group and the contract of subordination.

According to corporate law, full domination exists when one company holds 100% of the share capital of another. In addition, a group may exist in cases where two or more companies enter into a contract where they submit themselves to a unitary and common management (parity group contract) or one of them subordinates its management to another company (subordination contract).

In contrast, for accounting purposes, Portuguese law refers to the concept of control, which is defined, in broad terms, as the power to manage the financial and operational policies of an entity or economic activity in order to obtain benefits from it. It is also presumed that there is control over another entity when the parent company holds more than half of the voting rights of the other entity, unless it can be proved that such ownership is not control. Even if the parent company has no more than half of the voting rights of the other entity, it can have control if it has:

a) The power over more than half of the voting rights of the other entity due to an agreement with other investors; or
b) The power to manage financial and operational policies of the other entity under a statutory provision or an agreement; or
c) The power to appoint or dismiss the majority of the members of the management of the other entity; or
d) The power to group the majority of votes at meetings of the management of the other entity.

The parent company that controls one or more subsidiaries must elaborate consolidated financial statements which does not replace (but complements) the obligation of each company to present individual accounts.

From a tax perspective, the Portuguese IRC Code foresees an optional and special regime for the taxation of group of companies, the so-called *Regime Especial de Tributação de Grupos de Sociedades* (RETGS).

Such regime was introduced in 2000, having in mind that tax policy should not interfere with the choice of the organizational structure of businesses and therefore tax neutrality should be assured in the context of the group of companies. Besides, the rationale underlying the conception of the *REGTS* was to avoid economic double tax taxation and prevent tax evasion through the neutralization of any potential tax advantages that would arise from the transfer pricing or thin capitalization rules. Such regime is also in accordance with the Portuguese constitutional principle that prescribes the freedom of the business's initiative and organization.

It should be noted that the Portuguese domestic group taxation regime does not follow a pure tax consolidation model, namely since intra-group transactions between the companies within the perimeter are not eliminated for tax purposes.

For IRC purposes, a group of companies is considered to exist where a company (dominant company) holds directly or indirectly at least 75% of the share capital of other companies (controlled companies), as long as such participation confers to the dominant company more than 50% of the voting rights of the controlled companies.

Under the RETGS, the dominant company may elect to aggregate the taxable profits and losses of any other company included in the same group of companies. When that option is chosen, all the eligible companies must be included in the RETGS perimeter to avoid "cherry picking" issues, among others.

To enter a tax group, a set of cumulative conditions should be met, with the dominant company being liable to prove that such conditions are fulfilled.

The companies included in the tax group are required to have their head office and place of effective management in Portugal and all their income is subject to the general IRC regime at the highest rate. This means, for example, that companies covered by the tax transparency regime do not fulfill such requirement and, as such, are not allowed to be part of a tax group.

Additionally, the dominant company shall hold the participation in the share capital of the controlled companies for more than one year[9] and it should not have opted out of the RETGS in the three previous years, in both situations with reference to the date in which the RETGS starts to apply.

It should be also noted that the dominant company cannot be controlled by any other Portuguese resident company that fulfills the requirements to be qualified as dominant.

Moreover, the Portuguese IRC Code sets forth negative requirements for the RETGS to apply, such as the impossibility to be part of the RETGS companies which in the beginning or during the application of the RETGS are in one of the following situations:

a) Have been inactive[10] for more than one year or have been dissolved;
b) Are subject to a special corporate recovery or insolvency process;

[9] With the exception of the companies set up by the dominant company or other company of the group for less than one year, provided that the level of detention of at least 75% be held since the constitution.

[10] In the absence of a proper definition of "inactive company", the Portuguese Tax and Customs Authority used to understand that a company is inactive when it is does not register any profits or losses on the books. However, Tax Arbitral Court has already ruled that a company is considered to be inactive to this effect when the profits and losses registered on the books are circumscribed to the manutention of the company and are not related with the operation of any effective economic activity.

c) Register tax losses in the three years prior to the application of the special regime;[11]
d) Are subject to an IRC rate lower than the highest standard rate and do not waive to its application;[12]
e) Adopt a tax period different from that of the dominant company;[13]
f) Do not assume the legal form of a limited liability company (*sociedade por quotas*), of a corporation (*sociedade anónima*) or of a limited partnership limited by shares (*sociedade em comandita por ações*).

The RETGS ceases when any of the mandatory requirements concerning the dominant company are no longer fulfilled or when the taxable profits of any of the entities included in the group of companies are determined through indirect methods.

In light of the specific rules regarding the deduction of tax losses when the RETGS applies, it should be highlighted that tax losses from previous periods to the beginning of the RETGS can only be deducted to the taxable income of the group until the limit of the taxable income of the companies they refer to.

In the same way, net finance expenses not yet deducted regarding periods preceding the period in which the RETGS starts to apply can be considered on the computation of the taxable income of the five following tax periods up to the limit of EUR 1 million correspondent to the company they refer to, individually assessed. On the other hand, the unused part of the limit of 30% of the earnings before interest, taxes, depreciations and amortizations (EBITDA), as defined by the IRC rules, which may be carried forward for a period of five fiscal years, can only increase the maximum deductible amount of the net finance expenses correspondent to the company they refer to, individually assessed.

In summary, each company of the group should self-assess its own individual taxable profit in the correspondent annual IRC return as if the RETGS was not applicable, being the taxable profit of the group assessed by the dominant company through the algebraic sum of the individual taxable profits and losses of each company of the group.[14] The dominant company may opt for the net finance expenses of the group to be deductible until the limit of EUR 1 million, regardless of the number of the companies included in the group, or, if higher, until the limit of 30% of the tax EBITDA of the group, assessed through the algebraic sum of the tax EBITDA of each one of the companies of the group.

The IRC due shall be paid by the dominant company but all the companies of the group are jointly liable for such payment.

From the taxpayers' perspective, the main advantage of the RETGS is that, as a rule, and under certain limitations, it allows the offset of profits and losses of the companies which

[11] Except in the case of controlled companies when the dominant company has held them for more than two years.

[12] The Portuguese Tax and Customs Authority has already ruled that for a controlled company established in Azores, where a lower IRC rate is applicable (in comparison with the IRC rate applicable in the Portuguese mainland), to be part of the RETGS, it should waive the IRC rate of Azores and elect the standard IRC rate of the Portuguese mainland.

[13] The purpose of this negative requirement is to assure the homogenization and the comparability of the tax results of the companies of the group. In this regard, the Portuguese Tax and Customs Authority considered that all the companies of the group are not required to adopt, in their separate accounts, the same accounting standards. In that case, the homogenization on the assessment of the tax results is granted by the adjustments to be made under the IRC Code.

[14] The municipal surcharge as well as the state surcharge are also assessed by reference to the taxable profit of each company of the group.

are included in the group. From our perspective, another relevant advantage is that the income derived from intra-group transactions is not subject to IRC withholding tax provided that such income concerns periods in which the RETGS is in force. Besides, one can conclude that, in the context of the RETGS, transfer pricing adjustments may become redundant, thus reducing the risk of practical adverse impacts arising from different interpretations by the Portuguese Tax and Customs Authority on the arm's length principle.

In our opinion, the main downside of the RETGS is that tax losses generated within the group can only be used within the group perimeter. Moreover, as the autonomous taxation rates are determined in accordance with the aggregate tax result of the group and they are increased by 10% when the tax result of a certain period is negative, the RETGS may be disadvantageous in a scenario where some companies have a positive tax result but the aggregate tax result of the group is negative.

1.4. Change of control rules

Portuguese IRC Code provides for quite relevant change of control rules regarding tax losses and net financing expenses.

In this sense, Portuguese tax law allows for the carry forward of tax losses[15] for the five following tax periods or, in case of a micro, small or medium company,[16] for the twelve following tax periods. However, tax losses carried forward may be lost in case of change of the ownership of the company (that generated the losses) in more than 50% of its share capital or in the majority of the voting rights.

Also, taxpayers are allowed to carry forward the unused part of the excess of net financing expenses that were not deducted in previous years as a result of the application of certain limits as well as the carry forward of the unused part of net financing expenses lower than those established limits. Similar to the tax losses regime, the carry forward of the net financing expenses may also be lost in the event of a change of ownership of 50% of the share capital or of the majority of the voting rights.

Nevertheless, the change of control provisions allows some exceptions, duly identified in the IRC Code, as is the case of the change of control derived from transactions performed under the Portuguese tax neutrality regime.[17]

Furthermore, the Portuguese IRC Code also gives the possibility to request the Minister of Finance to authorize the limitations not to apply in case of proved recognized economic interest.

15 Carry back is not available in Portugal.

16 As defined by Portuguese Decree-Law 372/2007, from 6 November 2007.

17 The Portuguese tax neutrality regime results from the transposition of the Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different member states and to the transfer of the registered office of an SE or SCE between member states.

1.5. Relevance of belonging to a group/control in other contexts

1.5.1. Special anti-avoidance rules depending on "group" or "control"

The domestic tax group regime provides for a specific anti-avoidance rule under which companies with tax losses recorded in the three previous years before the beginning of the RETGS are not allowed to be included in the tax group, unless the dominant company has held the controlled companies for more than two years.

From our perspective and as the Portuguese case law states, the main reason for this specific anti-abuse measure is to avoid the inclusion in the perimeter of a tax group of companies with individual tax losses to be carried forward, with the only purpose being to decrease the overall tax result of the group and, consequently, to avoid taxation.

1.5.2. Special rules for the attribution of intra-group interest

As a rule, business expenses, including interest, are deductible for tax purposes, if they are necessary to obtain or guarantee income subject to IRC. However, the tax deductibility of financing expenses may be subject to certain limits in order to avoid the debt financing as well as the tax evasion that may arise in the context of multinational groups with a channel to shift profits to affiliates in low-tax countries.

Please note that the Portuguese rule which imposes limits to the tax deductibility of the net finance expenses closely follows the Organization for Economic Co-Operation and Development (OECD) guidelines laid down in Action 4 of the Base Erosion and Profit Shifting (BEPS) project[18] and was amended in 2019, due to the transposition of the Anti-Tax Avoidance Directive (ATAD).[19]

As per the Portuguese IRC Code, net finance expenses may be deducted up to the greater of the following limits:

a) EUR 1 million or;
b) 30% of the EBITDA as determined by the tax rules.

In this context, it is relevant to note that EBITDA's concept corresponds to the taxable profits or tax losses subject and non-exempt from IRC, plus net finance expenses and tax-deductible amortizations and depreciations.

Any excess of net finance expenses of a given tax year may be carried forward for a period of five fiscal years, provided that, together with the net financing expenses of the year, the above-mentioned limits are not exceeded. On the other hand, when the amount of net financial expenses considered as tax deductible is lower than the limit of 30% of the EBITDA, the unused part of that limit may be carried forward for a period of five fiscal years (increasing the maximum deductible amount), until that remaining part is fully used.

In this matter it is important to stress that the Portuguese rule is stricter than the directive, since the latter allows for a limit of EUR 3 million and Portugal has not amended the lower limit of EUR 1 million. Additionally, the directive authorizes the carry forward of

[18] OECD/G20 Base Erosion and Profit Shifting Project, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report.

[19] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

the excess of net finance expenses for unlimited periods while the Portuguese legislator kept such possibility limited for a period of five fiscal years. Besides, the directive allows for the carry back of the excess of net finance expenses limited to the three preceding years, while such option is not available in Portugal.

As mentioned above, the Portuguese IRC Code also imposes a shareholders' loan maximum interest rate corresponding to Euribor 12 month plus a 2% spread (6% spread in the case of medium-sized enterprises), above which its tax deductibility will be denied except when a higher interest rate can be justified under transfer pricing rules.

Regarding companies taxed under the RETGS, the dominant company may elect to apply these rules on a group basis, i.e., the above-mentioned limits are EUR 1 million, regardless the number of companies belonging to the group or 30% of the sum of the EBITDA of each one of the companies included in the group. Net finance expenses of the group as well as the unused part of the limit referent to tax periods in which the RETGS applies can only be used within the group, regardless of the exit of one or more companies of the group.

1.6. Special rules at the local or regional level for the profit allocation in groups of companies

Besides the standard IRC rate, a municipal surcharge and a state surcharge may also apply.

The municipal surcharge is levied by the municipalities at variable rates up to 1.5% of the taxable profit of the year, being the actual rate defined on an annual basis according to the decision of each municipality.

Such municipal surcharge is an important instrument of tax policy used by the municipalities to attract investment for their territories. In this way, municipalities usually grant an exemption or a reduction of this surcharge depending on the companies' turnover, the number of jobs maintained and created or the development of specific activities.

Furthermore, corporate taxpayers are also subject to a state surcharge of 3%, for taxable income from EUR 1.5 million to EUR 7.5 million, of 5% for taxable income from EUR 7.5 million to EUR 35 million, and of 9% for taxable income exceeding EUR 35 million.

In the context of the RETGS, both surcharges are still assessed by reference to the individual taxable profit of each company of the group, which means that municipal and state surcharges may be due and paid even when the group as a whole does not assess taxable profit.

1.7. Special tax procedure rules for associated corporations and controlled groups

Associated legal entities and controlled groups are independently audited for tax purposes.

Apart from the large taxpayers, which are regularly monitored by the Portuguese Tax and Customs Authority, there are no specific procedures in force regarding the tax audit of these companies.

Note that, in the context of the RETGS, the dominant company must communicate to the Portuguese Tax and Customs Authority the option for this special regime as well as any change in the group and the waive or the cease of such special regime. Furthermore, companies taxed under the RETGS shall present every year a tax file containing tax and accounting information available to the Portuguese Tax and Customs Authority.

Besides, please note that multinational groups are required to comply with country-by-country reporting, as we will further analyze.

Part Two: Separate entity approach and group approach in cross-border situations

2.1. Taxation of foreign corporate entities

Companies without their head office or place of effective management in Portugal are considered as non-resident entities.

According to the legislation in force, Portuguese IRC is levied on profits attributable to a Portuguese PE of a non-resident entity, as well as on Portuguese sourced income obtained by a non-resident entity with no PE located in the Portuguese territory.

Non-resident entities with a Portuguese PE must fulfill their accounting obligations and their taxable profit is assessed in identical terms as the Portuguese resident companies. The general management expenses attributable to PEs can be deducted on the assessment of their taxable profit, provided that transfer pricing rules are observed, and the apportionment criteria are maintained throughout the tax periods. When it is not possible to get an allocation based on the use by the PE of the goods and services to which the general expenses regard, apportionment criteria like turnover, direct expenses and tangible fixed asset can be applicable. .

In this regard, we also consider relevant to note that income obtained in Portuguese territory by non-resident entities derived from identical or similar activities as those performed by an existing PE in Portugal as well as income derived from the sale to individuals or entities with residence, head office or effective management in Portuguese territory of goods identical or similar to those sold through that PE, are also attributable to the PE.

n contrast, when a different treatment does not result from a double tax treaty (DTT), non-resident entities with no PE in Portugal are generally taxed through a final withholding tax at a rate of 25%, except regarding rental income, capital gains and some investment income obtained in Portugal which triggers the obligation to file an IRC return and, in certain circumstances, to appoint a tax representative.[20]

Finally, depending on the fulfillment of a set of requirements, a tax benefit concerning the capital gains obtained in Portugal by non-resident entities with no PE may be granted and such income may be exempt from IRC.

2.2. Treatment of branches (inbound and outbound)

According to the Portuguese IRC rules as well as to the DTTs signed by Portugal, which always prevail over the Portuguese domestic tax rules, a PE is defined as a fixed place of

[20] When the non-resident entity is non-resident in another member state of the EU or in a member state of the Economic European Area (EEA) bound to administrative cooperation in the field of taxation equivalent to that established within the EU.

business through which an activity of a commercial, industrial or agricultural nature is carried on, such as a branch.

In Portugal, a PE does not have legal personality and it is deemed to be the *longa manus* of the head office. Therefore, the transactions between PEs and their head offices are deemed as internal transactions or financial flows within the same entity, which do not give rise to tax-deductible costs or taxable profits. As per accounting legislation, all transactions performed by PEs of Portuguese companies shall be integrated into the books of the latter.

It is important to mention that, due to the IRC reform that occurred in 2014, the different tax treatment between foreign subsidiaries and foreign PEs was mitigated, and Portuguese companies may opt for the profits and losses of foreign PEs to be not considered on the assessment of their taxable profit, provided that a set of conditions are cumulatively met.

Concretely, profits attributable to the PE shall be subject to and not exempt from a tax provided in the Parent-Subsidiary Directive or a similar tax to the Portuguese IRC which tax rate is not less than 12.6% (i.e., 60% of Portuguese IRC rate of 21%), the PE should not be located in a blacklisted jurisdiction as considered by the Portuguese tax law and the tax effectively paid shall not be lower than 50% of the tax that would be due under the Portuguese IRC Code.

Furthermore, the last condition above is not applicable when the sum of the income of the foreign PE from one or more of the following categories does not exceed 25% of its total income:

a) royalties or other income derived from intellectual property rights, image rights or similar rights;
b) dividends and income arising from the disposal of shares;
c) income arising from financial leasing;
d) income arising from banking and financial activities, even when not carried out by credit institutions, insurance activities or any other financial activities performed with related entities;
e) income obtained by invoicing entities whose income arises from transactions made with related entities and that add no or little economic value; and
f) interest or other capital income.

The option in question is not available for the profits assessed by the foreign PE from its taxable income, up to the amount of tax losses assessed by such PE as have concurred to determine the Portuguese company's taxable income in the previous five fiscal years, or the previous twelve fiscal years for small and medium companies.

When such option is chosen, it shall cover, at least, all PEs located in the same jurisdiction and shall be maintained for a minimum period of three years. Moreover, the taxable profit of the Portuguese companies shall reflect transactions with the foreign PEs adjusted from the expenses correspondent to the income or assets attributable to these PEs in view to correspond to the taxable profit that would be obtained if these were separate and independent companies.

For the purposes of determining the taxable profit attributable to each PE, Portuguese companies shall adopt appropriate and duly justified criteria for the proportional allocation of expenses, losses or negative asset variations that are related either to transactions attributable, or to assets related, to a PE, or to other transactions or assets of the Portuguese companies.

The application of this regime precludes the application of any method intended to avoid double taxation regarding profits and losses attributable to foreign PEs.

Finally, note that Portugal does not provide for any PE remittance tax and the PEs located in Portugal are entitled to benefit by themselves from the DTTs entered into force by Portugal in light of the non-discrimination principle which demands that PEs should be treated on identical terms as domestic companies.

2.3. Treatment of income from foreign subsidiaries

In order to avoid economic double taxation that may arise when the income obtained by a foreign subsidiary of a Portuguese parent company is taxed in the jurisdiction where the foreign subsidiary is resident and, subsequently it is also considered on the taxable profit of the Portuguese parent company, Portugal provides for a domestic participation exemption regime.[21]

When such regime is not applicable (e.g., when the conditions are not met), a tax credit for the tax paid abroad may be granted in Portugal. The tax credit should correspond to the IRC paid in the foreign jurisdiction or to the amount of the IRC assessed before the deduction, corresponding to the net income that may be taxed in the foreign country, whichever is lower.

When a DTT applies, the tax credit shall not exceed the tax paid abroad pursuant to the terms established by the DTT.

Finally, it should be noted that depreciation of shares in foreign subsidiaries is not tax deductible in Portugal.

2.4. Application of group taxation regimes to cross-border groups and DTT entitlements of groups

Since 1 January 2015, foreign companies that meet the conditions to be considered a dominant company may also be elected for the RETGS. In this case, the RETGS would be applicable to all controlled companies resident in Portugal (that meet the referred conditions for the controlled companies) as well as to their PEs in Portugal through which the participations in the controlled companies are held.

Such regime was introduced in the context of the IRC reform that occurred in Portugal in 2014, with the aim to adapt the Portuguese legislation to the Court of Justice of European Union (ECJ) case law on judgments *Société Papillon*[22] and *SCA Group Holding BV*.[23]

In order to be eligible for the RETGS, the dominant foreign company shall:

a) Be resident in an EU member state or in a state of the EEA, but in the latter case only if administrative cooperation at the level of taxation equivalent to those existing within the EU is in force;
b) Hold the participation in the controlled companies for more than one year with reference to the date in which the RETGS begins to apply;
c) Not be held, directly or indirectly, for at least 75% of its share capital, by a company resident for tax purposes in Portugal that fulfills the requirements to be considered as

[21] See s. 1.2.

[22] ECJ, 27 November 2008, Case C-418/07.

[23] ECJ, 12 June 2014, Cases C-39/13, C-40/13 and C-41/13.

a dominant company, provided that such participation confers more than 50% of the voting rights;
d) Not have opted out of the application of the RETGS in the three years preceding the date the RETGS starts to apply;
e) Be subject to and not exempt from a tax provided in the Parent-Subsidiary Directive or a similar tax to Portuguese IRC;
f) Assume the legal form of a limited liability company.

A dominant foreign company which holds a PE in Portuguese territory through which it holds the participations in the controlled companies ,may also be eligible for the RETGS if any of the negative requirements mentioned in section *1.3 Group taxation regimes* do not apply to that PE.

Considering the dominant company is non-resident in Portugal, when a PE exists in the Portuguese territory it is mandatory liable to comply with all the obligations that arise from the RETGS. In the absence of a PE in Portugal, a controlled company resident in Portugal must be appointed before the Portuguese Tax and Customs Authority to this effect. Nonetheless, the dominant foreign company is still jointly liable with all the entities included in the group for the payment of the IRC due.

In this regard, it is important to note that the Portuguese Tax and Customs Authority has already ruled that PEs other than the PE of the dominant foreign company cannot be part of a tax group in Portugal. In contrast, Portuguese subsidiaries held directly or indirectly by the dominant foreign company through subsidiaries resident in Portugal or in an EU member state or in a state of the EEA[24] may be taxed under the RETGS.

Groups of companies taxed under the RETGS are not entitled to benefit from the DTTs signed by Portugal. In fact, the benefits of the DTTs should be claimed individually by each entity that is part of the tax group.

2.5. Transfer pricing rules

The Portuguese transfer pricing regime closely follows the OECD guidelines and was recently amended in order to be aligned with conclusions reached in Actions 8-10 of the BEPS project.[25]

According to the Portuguese transfer pricing regime, transactions carried out between a taxable person and any other related entity, whether or not subject to IRC, shall be subject to terms or conditions substantially identical to those that would normally be agreed, accepted and practiced between independent entities in comparable transactions.

As a result of the recent amendment, the scope of transactions covered by the transfer pricing regime is now wider, being applicable to commercial transactions, including any operation or series of operations regarding tangible or intangible assets, rights or services, even if carried out within the scope of any agreement, namely the sharing of costs and the provision of intra-group services, as well as financial operations and corporate restructuring

[24] In this case, only if administrative cooperation at the level of taxation equivalent to that existing within the EU is in force.

[25] OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports.

or reorganization operations that involve changes in business structures, the termination or substantial renegotiation of existing contracts, especially when they involve the transfer of tangible or intangible assets, rights over intangible assets, or compensation for emerging damages or lost profits.

Besides, the transfer pricing methods are no longer hierarchical, and taxpayers are allowed to pick any of them, taking into account, for that choice, *inter alia*, the nature of the transaction, the availability of reliable information and the degree of comparability between the transactions or series of transactions carried out and others that are substantially identical, carried out between independent entities.

As far as we can understand, at this stage there is not a tendency, in Portugal, to apply new group-related allocation rules for profits as discussed under OECD BEPS Pillar 1.

2.6. CFC regimes and separate entity approach

The Portuguese IRC Code provides for a specific anti-avoidance rule to address the problem of the allocation of results of controlled foreign companies. Particularly, the Portuguese CFC rules aim to avoid the deferral of taxation and the accumulation of income in companies located in low-tax jurisdictions merely for tax reasons.

The provision in question was recently amended following the transposition of the ATAD and, from our perspective, there might be a tendency to extend domestic CFC regulations toward the full inclusion, as proposed by the OECD BEPS Pillar 2. We believe that, in this scenario, the effective tax burden for the application of the minimum tax would be determined per entity.

According to the Portuguese CFC rule, the income or profits obtained by non-resident entities subject to a clearly more favorable tax regime is allocated to Portuguese IRC taxpayers who hold, directly or indirectly, even if through a trustee, fiduciary or interposed person, at least 25% of the shares, voting rights or rights over the income or assets of such entities.

The allocation shall be made on the taxable basis of the Portuguese taxpayer by the amount of profit or income obtained by the non-resident entity determined under the terms of the Portuguese IRC Code and in accordance with the proportion of the capital or the rights over the income or patrimonial elements held, directly or indirectly, even if through a trustee, fiduciary or interposed person, by the Portuguese taxpayer.

The income or profits subject to allocation shall be deducted from the IRC levied on such profits or income, which shall take place in accordance with the tax regime applicable in the state of residence of that non-resident entity.

Besides, tax losses assessed by the non-resident entity under the terms of the Portuguese IRC are deductible to the extent they correspond to the proportion of the capital or the rights over the income or patrimonial elements held, directly or indirectly, by the Portuguese taxpayer, up to the allocated income in one or more of the following five tax periods.

In light of the Portuguese provision, an entity is considered to be subject to a clearly more favorable tax regime when it is resident in a blacklisted jurisdiction as defined by the Portuguese law or, alternatively, in a situation in which the IRC effectively paid is lower than 50% of the IRC that would be due under the Portuguese IRC Code.

Notwithstanding, the Portuguese CFC rule does not apply to non-resident entities whose sum of the income from one or more of the following categories does not exceed 25% of their total income:

a) royalties or other income derived from intellectual property rights, image rights or similar rights;
b) dividends and income arising from the disposal of shares;
c) income arising from financial leasing;
d) income arising from banking business activities, even when not carried out by credit institutions, insurance activities or any other financial activities performed with related entities;
e) income obtained by invoicing entities whose income arises from transactions made with related entities and that add no or little economic value; and
f) interest or other capital income.

Lastly, it should be noted that the CFC provision is not applicable when the non-resident entity is resident or established in another member state of the EU or in a member state of the EEA (in the latter case provided that this member state is bound to administrative cooperation in the field of taxation equivalent to that established within the EU) and the taxable person demonstrates that the constitution and operation of the entity correspond to valid economic reasons and that that entity carries out an economic activity of an agricultural, commercial, industrial or service nature, using employees, equipment, assets and facilities.

2.7. Intra-group withholding taxes or non-deductibility of outbound payments

The Portuguese IRC does not distinguish the tax treatment applicable to payments made to non-resident entities in a context of groups of companies or on a standalone basis.

Considering that Portugal has transposed the Parent-Subsidiary Directive as well as the Interest-Royalty Directive,[26] dividends, interest, and royalties paid by a Portuguese resident company to a company resident in an EU or EEA state may be exempt from withholding tax in an EU/EEA context or even when a DTT is in force.

When such provisions do not apply, and a DTT is not in force, withholding tax at a rate of 25% is due (35% if the beneficiary is an entity resident in a blacklisted jurisdiction as defined by the Portuguese law).

2.8. Scope of the application of hybrid mismatch rules

The domestic participation exemption regime provides for an anti-hybrid rule pursuant to which such exemption does not apply when the distributing entity deducts the distributed dividends from its taxable income.

Following the transposition of the ATAD, Portugal has very recently laid down further specific and quite complex rules intended to neutralize the effects of hybrid mismatches, including tax residency mismatches.

Even though they are already designed and foreseen in the Portuguese IRC Code, some of the specific rules will only produce their intended effects from 1 January 2022 onwards.

[26] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states.

In general terms, a hybrid mismatch is considered to exist in a context that involves associated companies, a taxable person and an associated company, the head office and the permanent establishment, two or more permanent establishments of the same entity or a structured agreement.

To this effect, the following are qualified as associated companies:

a) an entity in which the taxable person holds, directly or indirectly, at least 25% of the share capital, voting rights or rights over the income of that entity;
b) a person or entity in which the taxpayer owns, directly or indirectly, at least 25% of the share capital, voting rights or rights over the income of that entity;
c) entities that are part of the same group of entities fully included in the consolidated financial statements elaborated in accordance with international financial reporting standards or the accounting standard-setting system;
d) entities that have significant influence over the management of the taxable person or over the management of which the taxable person has significant influence.

According to the Portuguese anti-hybrid rules, a different allocation of income may trigger anti-hybrid rules and the mismatch considers the abstract application of foreign tax rules.

2.9. Scope of country-by-country reporting

As a result of the BEPS Action 13[27] and in order to increase transparency, multinational groups are required to comply with country-by-country reporting. Thus, the ultimate parent company, or the substitute parent company, of multinational groups whose total consolidated income, as reflected in its consolidated financial statements, is, in the immediately preceding period, equal to or greater than EUR 750 million, shall submit a statement disclosing detailed financial and tax information by each country or tax jurisdiction related to the entities included in that group.

Furthermore, the entity resident in Portugal, other than the ultimate parent company of a multinational group, may also submit a declaration by country or tax jurisdiction, for each tax period, if one of the following conditions is met:

a) it is directly or indirectly owned or controlled by non-resident companies that are not required to submit an identical declaration;
b) in the jurisdiction where the ultimate parent company is resident there is an international agreement with Portugal in force but, by the deadline to submit the country-by-country report, there is no qualified agreement between the competent authorities; or
c) there is a systemic failure in the jurisdiction where the ultimate parent company is resident that the Portuguese Tax and Customs Authority has notified to the constituent company.

[27] OECD/G20 Base Erosion and Profit Shifting Project, Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: 2015 Final Report.

2.10. Scope of application of other instruments

Currently, Portugal does not provide for any diverted profit tax nor does there exist, in our opinion, a tendency to implement national special instruments for cross-border groups.

In fact, considering the high level of implementation that BEPS has in the Portuguese corporate tax framework as well as the recent transposition of the ATAD, we consider that material changes are not expectable soon.


International Fiscal Association