

THE EXECUTIVE
REMUNERATION
REVIEW

SIXTH EDITION

Editors

Arthur Kohn and Janet Cooper

THE LAWREVIEWS

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PORTUGAL

José Pedro Fazenda Martins, Tiago Piló, Inês Gomes Ferreira and Rita Magalhães¹

I INTRODUCTION

With an average monthly salary of €1,000 and the freeze on salary increases owing to the financial crisis and the bailout, executive remuneration systems have not been a hot topic in Portugal over the past few years.

The main concern has been on state-owned enterprises. In the wake of the financial crisis and the ensuing bailout, Portugal agreed with the Troika austerity measures with a view to reducing public spending and, hence, the budget deficit. Some of those measures, such as those with a view to reducing operational costs, namely by limiting the salaries and other benefits paid to public managers, had already been introduced; others, such as EU-driven initiatives on the financial sector, have not.

However, since it seems that the worst years of the crisis are well behind us, there is an increasing demand for assisting companies structure remuneration schemes for their top people.

II TAXATION

i Income tax for employees

This section intends to cover taxation applicable to executives employed under a labour contract and not to executives who are members of the company's statutory board.

ii Employment income

In general terms, all remuneration paid to executives is considered, for tax purposes, as taxable income.

Taxable income includes wages, salaries, fees, bonuses, commissions, tips, grants or awards, shares in fines, penalties and other additional remuneration, whether periodic, fixed or variable, and whether of a contractual nature or not.

iii Territoriality

Individuals resident in Portugal are subject to personal income tax on their worldwide income, regardless of whether such income is obtained in the Portuguese territory or abroad.

¹ José Pedro Fazenda Martins is a partner and Tiago Piló, Inês Gomes Ferreira and Rita Magalhães are managing associates at Vieira de Almeida. The authors gratefully acknowledge the assistance of Joana Branco Pires and Mariana Ferraz Viveiros (associates).

The following individuals are qualified as residents in Portugal with respect to the year in which the taxable income is obtained:

- a individuals who have spent more than 183 days in the Portuguese territory, continuous or not, in any given period of 12 months with the beginning or the end on that year;
- b individuals who have remained in Portugal for a shorter period but keep residential accommodation in Portugal in any day of the above-mentioned period, which suggests an intention to maintain and occupy it as an usual residence; and
- c non-resident individuals are subject to tax only on their Portuguese source income (e.g., remuneration arising from activities carried out in Portugal or paid by a resident entity).

Nationality does not have an impact on taxation applicable to employment income.

iv Tax rates

Individuals resident in Portugal are taxed by aggregating income from several sources (employment income, business and professional income, investment income, rental income, net worth increases and pension income) after any allowable deductions have been made.

Tax residents must file a personal income tax return and will have their employment income included with their global worldwide income, which will be subject to personal income tax at general increasing tax rates that depend on the aggregated income.

For the tax year 2017, the general rates of personal income tax may vary from 14.5 per cent in respect of income of up to €7,091 to 48 per cent in respect of income higher than €80,640. An additional income tax rate of 2.5 per cent will be payable on any part of such taxable income that exceeds €80,000 up to €250,000, while the part of the taxable income that exceeds €250,000 will be subject to an additional income tax rate of 5 per cent. A surcharge set at 0.88 per cent will also be applied to all taxable income that exceeds €20,261 up to 3.21 per cent in respect of income higher than €80,640.²

Non-resident individuals, if no double taxation treaty applies, will have their employment income resulting from work performed in Portugal, or paid by a Portuguese entity, subject to a final withholding (of 25 per cent) on gross income received without any deductions being allowed. They will not have any other tax obligations (i.e., the need to file a tax return). For the non-habitual residents' special regime, see below.

v Stock option plan and stock subscription or attribution plan

The relevant moment for taxation purposes differs whether the plan is considered, in light of the Portuguese tax law, as a 'stock option plan' or a 'stock attribution or subscription plan'.

On a stock option plan the granting of the options does not trigger any taxation, since the relevant taxable event takes place when the employee exercises his or her right. The taxable income will amount to the positive difference between the fair market value of the underlying shares on the exercise date and the exercise price paid by the employee. This income should be treated as employment income.

2 To the third income bracket, this surcharge will apply to income earned up to 30 June 2017. In the fourth and fifth brackets, this surcharge will apply to income earned up to 30 November 2017. The third income bracket includes income from €20,261 up to €40,522, the fourth income bracket includes income from €40,522 up to 80,640 and the 5th income bracket includes income higher than €80,640.

On a stock attribution or subscription plan, if there is a restriction period in which employees (1) will not buy the shares, (2) are not allowed to sell the shares, (3) will be excluded from the plan if dismissed by the employer with cause and (4) are unable to benefit from other shares' rights (such as dividends or voting rights), the plan will be taxed when the restriction period ends and the employees are vested on all rights over the shares. The taxable amount is the difference between the shares' market value at the day the restriction period terminated and the amounts paid by the employees. This income should be treated as employment income.

If the plan does not comply with the above-mentioned conditions, it shall be taxed when the employees receive the shares. The taxable income will amount to the positive difference between the price of subscription paid by the general subscribers and the price paid by the employee. If there are no general subscribers, the relevant difference shall be between the fair market value and the price paid by the employee. This income should be treated as employment income.

Potential income resulting from the future sale of the shares is taxed as a capital gain (except if the sale is made to the employer case in which such gain will be taxed as employment income).

vi Social taxes for employees

As a general rule, all payments made by the employer to the employee on account of the execution of the employment contract are liable to pay social security contributions.

The amount of the contribution is generally calculated by applying a contribution rate to the gross remuneration. Although the social security contribution rates vary in accordance to several factors, they are, as a general rule, shared between the employer (23.75 per cent) and the employee (11 per cent).

Finally, compensatory payments resulting from non-competition covenants are exempt from social security contributions.

vii Tax deductibility for employers

In general terms, remuneration paid to employees is tax deductible by the employer under corporate income tax rules. There are, however, some restrictions regarding tax deductibility (e.g., per diem allowances, kilometres paid for using personal vehicles, balance sheet allowances) applied to all employees in general.

There are no specific rules applicable to the tax deductibility of remuneration paid to executives (who are not members of the company's corporate bodies) when compared to remuneration paid to rank-and-file employees.

Remuneration costs are tax deductible in the fiscal year in which the employee is entitled to the respective remuneration and not in the year of their payment by the employer.

III TAX PLANNING AND OTHER CONSIDERATIONS

Regarding executives moving to Portugal, there is a very favourable tax regime – the Non-habitual Tax Residents Regime (NHR) – which should be considered.

The NHR is one of the most competitive European regimes, in particular due to the following key features: no deemed taxation/'lump-sum' taxation, no limitation on the remittance of funds, no wealth tax and no gift or inheritance tax on funds or assets transferred to spouses, ascendants (e.g., parents) or descendants (e.g., children).

Moreover, this regime applies free of charge and is granted for a period of 10 years.

A non-habitual tax resident is an individual who becomes a tax resident in Portugal in a given year and was not taxed as resident in Portugal for any of the previous five years.

The benefits provided in the NHR range from a full exemption on certain types of income and a reduced flat tax rate of 20 per cent³ to other types of income, as follows:

Foreign-source income	Passive income earned outside Portugal (e.g., dividends, interest, pensions and rental income) is fully exempt in Portugal and this exemption applies irrespective of the taxation applicable at source (i.e., it is possible to achieve double non-taxation)
	Active income (e.g., income from employment and self-employment) earned in connection with 'high value added activities' may also be fully exempt provided specific conditions are met. The activities qualified as 'high value added' are identified in a statutory shortlist and include executives (i.e., senior company personnel, CEOs and CFOs)
Portuguese-source income	Active income (e.g., income from employment and self-employment) earned in Portugal in connection with 'high value added activities' will be subject to a flat rate of 20 per cent (instead of the general increasing tax rates)

IV EMPLOYMENT LAW

i Non-competition covenants

As a general rule, post contractual non-competition covenants are not enforceable in Portugal.

Without prejudice, such covenants would be enforceable under some specific terms and conditions. In fact, according to the Portuguese Labour Code, such covenants are enforceable provided the following requirements are cumulatively met:

- a* the maximum time for limitation is two years after the termination of the employment agreement, or three years if the nature of the activity implies a special relationship of trust, or if the employee has access to particularly sensitive information in terms of competition;
- b* the covenant is agreed in writing (in the employment contract or in the termination agreement);
- c* the activity that is being limited may in fact cause damages to the former employer; and
- d* the former employee is paid a compensation on account of the non-competition covenant, which means that a gardening leave (whereby the employee is not paid any amounts) may not be enforced throughout the non-competition period.

In terms of geography, there are no mandatory limitations, although they may result either from the business requirements of the employer or from the scope of limitations agreed on the non-competition covenants.

There are no specific provisions to regulate the amount of compensation to be paid on account of the non-competition covenants. In any case, such compensation (1) shall have to be fair and adequate in view of the restrictions to be complied with by the former employee, (2) shall be assessed on a case-by-case basis, and (3) may be lower than the employee's last monthly salary. Recent case law has held that non-competition covenants are enforceable

³ A surcharge of 1 per cent is applied to the taxable income that exceeds €7,070, up to 3.5 per cent in respect of income higher than €80,000. This surcharge will no longer apply to taxable income earned from 1 January 2017.

provided the compensation is agreed beforehand or, at least, both parties agree on the formula to be used to calculate such compensation (compensation is not decided at the company's discretion, upon termination, but rather by agreement between both parties).

The enforceability is not affected if the non-competition covenant is entered into in the context of a transaction rather than a termination of employment.

ii Rules governing the termination of employment agreements

After the trial period expires, a permanent employment agreement⁴ may only be unilaterally terminated by the employer with cause.⁵

Causes for termination of employment agreements by the employer are extensively regulated in the Portuguese Labour Code. These causes may be business or disciplinary related. In both cases, these causes have to determine that, in practical terms, it is impossible to keep the employee in the employer's service.

Termination by the employer for business-related reasons entitles the employee to receive severance for each year of service. The specific amount of the severance per year of service depends on the date the employee was hired, between 30 to 12 days of remuneration. Termination for disciplinary reasons does not entitle the employee to receive any severance.

The employee may challenge the dismissal⁶ in court. Should the court rule in favour of the employee, he or she will be entitled, *inter alia*, to be compensated for lost salaries, as well as to be reinstated or to receive a compensation⁷ to be settled by the court on a case-by-case basis, between 15 to 60 days of remuneration per year.

To avoid the risks of litigation, employers prefer to terminate the employee by means of an agreement. Although not mandatory, it is usual for employers to offer employees compensation on account of a general release of claims against the employer. Even though it is not mandatory, usually employees are offered a compensation higher than the one resulting from statutory provisions in connection with termination by the employer for business-related reasons.

iii Change of control

Change of control is not cause for termination of an employment agreement.⁸ As a result, a dismissal based solely on the employer's change of control would be deemed unlawful. In addition, a transfer of business is also not cause for termination. The underlying principle⁹ is that the employment agreements are transferred by way of law to the transferor company under the same terms and conditions.

4 Term employment agreements may be terminated under different conditions.

5 The employee may resign with a pre-notice of 30 or 60 days depending on the years of service or immediately, in case of just cause.

6 Either business or disciplinary-related.

7 In the case of executives, the company may plead the court to reject the reinstatement provided it demonstrates that the return of the executive shall be disruptive to its business.

8 Regardless of who takes the initiative: the employer or the employee.

9 In line with the Acquired Rights Directive which has been introduced into the Portuguese legal system.

iv Role of the works councils representing the employees

Works councils are entitled to be informed and consulted on several matters, namely, regarding the overall organisation, activity and company's budget, working conditions and change of the share capital, as well as to control the company's management and participate in the company's restructuring process.

V SECURITIES LAW

i Offers of securities to employees

Offers of securities to employees are not subject to registration and are in general exempted from the obligation to publish a prospectus (Article 134.º/2/c of the Securities Code).

However, the exemption to prepare and publish a prospectus only applies where the offeror has prepared a document containing sufficient information as regards the number and type of the securities offered and the rationale and description of the offer.

Where the total amount of the offer does not exceed €5 million, the offeror may also benefit from a general prospectus and public offers regime exemption provided for in Article 111.º/1/i of the Securities Code. However, there is no precedent in this regard and the Portuguese securities regulator tends to rely only on the specific exemption of Article 134.º/2/c of the Securities Code.

ii Rules applying to the sale of shares and other financial instruments held by executives

The Portuguese Securities Law did not provide for blackout periods under which executives are prevented for selling securities issued by their employer. However, since Regulation (EU) 596/2014 entered into force, a person discharging managerial responsibilities within an issuer with financial instruments admitted to a regulated market, to a multilateral trading facility or to an organised trading facility is forbidden from conducting any transactions on its own account or for the account of a third party, directly or indirectly, relating to the shares or debt instruments of a listed issuer or to derivatives or other financial instruments linked to them during a closed period of 30 calendar days before the announcement of an interim financial report or a year-end report which the issuer is obliged to make public.

However, the aforementioned issuer may allow a person discharging managerial responsibilities to trade within the closed period, on a case-by-case basis and under certain circumstances, such as severe financial difficulty, which require the immediate sale of shares or transactions made under, or related to, an employee share or saving scheme, qualification or entitlement of shares. According to ESMA's technical advice, it is a requirement for permission to trade that the person discharging managerial responsibilities can demonstrate that the particular transaction cannot be executed at another moment in time than during the closed period.

In any case, a person discharging managerial responsibilities that trades securities in the market while in possession of non-disclosed material information about the company that issued those securities remains subject to the prohibition on inside dealing and to criminal sanctions for insider trading and disgorgement of the profits.

Transactions entered into by company managers regarding the shares and debt instruments admitted to a regulated market, to a multilateral trading facility or to an organised trading facility issued by the company could be a relevant signal to the market. Moreover, greater transparency on such transactions will contribute to prevent market abuse. For these

reasons, Regulation (EU) 596/2014 provides for the notification of such transactions to the issuer and to their disclosure by the issuer to the market, once a total amount of €5,000 has been reached within a calendar year.

Individuals closely related to the managers are also obliged to disclose such transactions.

The managers' transaction regime covers not only the disposal or acquisition (including the subscription) of the financial instruments, but also pledging, borrowing or lending of financial instruments and transactions made under a life insurance policy, where the policyholder has the power or discretion to make investment decisions. The acceptance and the exercise of a stock option in case of stock options granted to managers and employees as part of their remuneration package, the sale shares stemming from the exercise of a stock option and gifts and donations are also subject to the regime, according to ESMA-related technical advice.

iii Hedging

Banks and other financial institutions and their employees are legally forbidden from hedging variable remuneration against the functioning of *malus* or clawback mechanisms.

For other types of companies, including listed companies, no legal prohibition prevents executives to hedge the stock options granted or other forms of variable pay. Nevertheless, hedging is not deemed a good governance practice, as it decouples remuneration from the performance of the stock of the company. In fact hedging may circumvent remuneration policies put in place by the company providing for the linkage between executive pay and business performance. Moreover, if hedging practices are not disclosed, it can mislead market and investors. From a corporate law perspective, this could be also considered a breach of fiduciary duties of executives to shareholders, as it breaches paramount principles and rules of executive remuneration that were approved by the shareholders.

VI DISCLOSURE

i **Listed companies in regulated markets, state-owned enterprises, insurance companies, certain credit institutions, venture capital companies and funds, and other 'public interest entities', as defined by article 3 of the Annex to Law No. 148/2015, 9 September**

These companies are required to present a statement on their remuneration policy which applies board and supervisory board members to be approved by the shareholders on an annual basis.

The statement on remuneration policy should include information, *inter alia*, on how the structure of executive remuneration contributes to alignment of the interest of Board members with the interests of the company; on the criteria to determine the variable pay; on the existence of stock options and pay in shares; on the possibility of deferral of variable pay and of implementation of *malus* or clawback mechanisms.

The statement on remuneration policy and the annual amount of remuneration received by Board and Supervisory Board members, both on an individual and aggregate fashion (Article 3.º of Law 28/2009, 19 June, amended by Decree-Law No. 157/2014, 24 October), should be disclosed to the public.

This broad disclosure obligation was adopted at the onset of the 2008 financial turmoil, and is being challenged because of its scope as it also covers, for instance, companies that only have short-term debt instruments listed admitted to the regulated markets.

ii Banks and other financial institutions (Article 115.º-B and following of the Credit Institutions and Financial Companies Legal Framework (the Banking Law))

The remuneration policy in banks and other financial institutions applies not only to board and supervisory board members, but also to senior management and key individuals in charge of internal control and risk management and to other employees whose activities have a material impact on the risk profile of the institution.

A statement on remuneration policy of the aforementioned board members and employees should be presented to and approved by the general shareholders meeting on an annual basis.

The legal framework for the variable remuneration is both very stringent and detailed for these institutions.

In principle, the variable remuneration cannot exceed the amount of the fix pay, but in specific situations, and if approved by a majority of two-thirds or three-quarters of the shareholders, the variable pay may double the fix pay. However, the central bank should be informed of such decision outright. It is mandatory for financial institutions to make the variable remuneration dependent upon *malus* and clawback mechanisms, along with the definition of clear criteria in applying them if an employee was responsible or contributed for significant losses in the business of the financial institution.

Disclosure to the Central Bank of all employees who perceive an annual remuneration exceeding €1 million is mandatory.

Financial institutions should also disclose to the public detailed information which can make evidence that the legal requirements above mentioned regarding remuneration policy are complied with by the financial institution. The Central Bank has some flexibility in detailing the type and amount of information it requires to financial institutions.

VII CORPORATE GOVERNANCE

The Portuguese legal framework regarding corporate governance rules on remuneration of the corporate bodies is provided for, in general terms, in the Portuguese Companies Code. Alongside these provisions, there are several other soft law instruments, currently mainly issued by the CMVM, which further set out rules and recommendations regarding the remuneration of the corporate bodies, and which are applicable to public companies. This framework is about to change as CMVM and the Portuguese Institute of Corporate Governance (IPCG) – which also published its Corporate Governance Code in 2013 – agreed on the existence of a unique code, to be issued by IPCG. The first draft has already been prepared and was subject to a public consultation process. The final version of the new Code is still being prepared.

i Portuguese Companies Code and Law No. 28/2009, 19 June

The Portuguese Companies Code provides that the corporate body responsible for determining the remuneration of the members of the management body varies depending on the corporate governance model of the company, as follows:

- a* One-tier management structure models (Classic and Anglo-Saxon models): the general meeting of shareholders or a remuneration committee appointed by the latter is responsible for determining the remuneration of all the members of the board of directors.

- b* Two-tier management structure model (German or dualistic model): the remuneration of the members of the executive board of directors is determined by the general and supervisory board or by its remuneration committee, except if the company's bylaws specifically attribute such competence to the general meeting of shareholders or to a remuneration committee, appointed by the latter.

In all the three governance models, the remuneration of the members of the management body may comprise a fixed and a variable component, the latter including profit sharing. The maximum percentage of profits aimed at directors shall be specifically authorised in the by-laws.

Law No. 28/2009, 19 June (amended by Decree-Law No. 157/2014, 24 October), imposes on public interest entities (as defined in Article 3 of the Annex to Law No. 148/2015, 9 September), the disclosure obligations regarding the remuneration policy of the members of the management (and supervisory) body referred to in Section VI, *supra*. These obligations are a 'say on pay' demonstration.

ii Regulations and recommendations issued by the CMVM

The CMVM has published non-binding regulations and recommendations regarding the remuneration of the members of the managing body, namely Regulation No. 4/2013, which states that public companies located or operating in Portugal shall adopt the CMVM Corporate Governance Code or a corporate governance code issued by an entity specifically suitable for said purpose. This regulation also recommends a corporate governance report model.

The CMVM Corporate Governance Code (2013) foresees additional information that shall be included in the statement on remuneration policy mentioned above.

Furthermore, and contrary to the Portuguese Companies Code, the CMVM Corporate Governance Code contains recommendations specifically applicable to executive directors of public companies. According to these recommendations:

- a* the remuneration of executive directors shall be based on their performance and discourage taking on excessive risks;
- b* the variable component of the remuneration shall be reasonable in comparison with the fixed component of the remuneration and maximum limits shall be set for both components;
- c* a significant part of the variable remuneration shall be deferred for a period of not less than three years and the right to its payment shall be dependent on the continued positive performance of the company during such period;
- d* directors shall not enter into agreements with the company or with third parties that intend to mitigate the risk inherent to variability of remuneration established by the company;
- e* appropriate legal instruments shall be established by the company so that in the event of a director's removal owing to inadequate performance, no indemnity or compensation is enforceable beyond that which is legally due;
- f* all members of the remuneration committee shall be independent from the executive directors and shall include at least one member with knowledge and experience in matters of remuneration policy; and

- g the approval of stock option plans or plans based on share price variation attributing directors the right to acquire shares or the approval of any retirement benefit schemes for members of corporate bodies shall be submitted to the general meeting of shareholders.

Executive directors shall maintain the company's shares that were allotted by virtue of variable remuneration schemes, up to twice the value of the total annual remuneration, until the end of their mandate.

VIII DEVELOPMENTS AND CONCLUSIONS

According to the majority of the indicators, the IMF/EU-imposed austerity package is finally showing some signs of success: the projections for the Portuguese economy published in the June 2015 Bulletin of the National Central Bank indicate that the steady recovery process started in 2013 shall continue. Also according to the National Central Bank, after a 1.4 per cent GDP growth in 2016, an increase to 1.8 per cent in 2017 is expected.

Consequently, foreign investment will certainly increase, pushed by the wave of privatisations agreed with the Troika and the need for Portuguese entrepreneurs to raise capital.

The surge of foreign investment will give way to an increased implementation of Anglo-Saxon inspired remuneration schemes. The trend will be for sure to focus on long-term incentives as opposed to short-term ones. This is to be combined with executive pay becoming truly variable – it should rise and fall with business performance and investor returns. Likewise, tax planning and other considerations to increase efficiency are also on top demand. Finally, the new Corporate Governance Code, soon to be issued by the IPCG (which shall include key and demanded governance principles defined by CMVM, and will be a sort of 'Combined Code' consolidating the CMVM's and IPCG's recommendations on corporate governance), will also have an impact on executive remuneration. We will have to wait for the final version to be issued, but as previously anticipated, improved and full disclosure of executive remuneration will most certainly be acknowledged and demanded throughout corporate governance codes or reports. The recommendations foreseen in the new Corporate Governance Code shall remain based on the 'comply or explain' principle and, consequently, companies shall maintain flexibility to decide on the adoption of the relevant recommendations.

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