

CORPORATE INCOME TAX REFORM: TAX SIMPLIFICATION AND INVESTMENT PROMOTION



TAX & BUSINESS



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I. ABSTRACT

One year after the Reform Commission has started its work, amidst heavy debate and several proposals, Law no. 2/2014 was published in the Republic Gazette on 16 January 2014, thus approving the corporate income tax reform and republishing the corporate income tax code accordingly.

Considering that, in the current economic scenario, any corporate tax regime plays a big role in economic development, even though it can generate important distortions in investment decisions and that the Portuguese regime has been in force for over 20 years, subject to recurrent changes to the tax legislation, specifically tailored amendments and the recent need to raise tax revenues, an in-depth reform of the tax system was of a vital importance to put Portugal forward as an attractive economy, both for Portuguese companies, as well as for foreign entities.

In accordance, the time has come to make an end-to-end revision of the current corporate tax regime, considering the need to revise and simplify the taxation of companies thus promoting investment – be it domestic, inbound or outbound –, the need to revise and simplify the current regime of ancillary obligations imposed on taxpayers thus reducing some of the existing bureaucracy and the need to restructure the current international tax policy followed by Portugal in its relations with other countries and its positioning in a globalized economy, namely as

regards the negotiation and conclusion of double taxation agreements.

Please find below a summary of the most relevant measures.

II. REDUCTION OF STATUTORY TAX RATES

Tax rates are typically perceived as the ultimate proxy for how burdensome a given tax system is.

Even though the effective tax burden relies on a myriad of elements, of which the nominal tax rate is just a small part, the most publicized measure is, probably, the reduction of the statutory tax rate to 23%.

Despite the fact that the current reduction is only of 2 p.p., it represents the first step towards the proposed reduction of the nominal tax rate to 19%, with the extinction of the existing (municipal and national) surtaxes, progressively, until 2016.

As a result of the political debate that was held on this matter, small and medium enterprises now benefit from a reduced tax rate of 17% applicable to the taxable income up to € 15,000.

In order to mitigate the revenue impact of the decrease of the tax rates, the state surtax now includes a 7% additional tax rate applicable to taxable income in excess of € 35,000,000.00.

III. (RE)INTRODUCTION OF A SPECIAL TAXATION REGIME FOR SMALL BUSINESSES

Considering that the Portuguese business sector is mainly composed of small and medium enterprises, Law no. 2/2014 reintroduces (a previous system had been repealed in 2010) a simplified tax system applicable to small businesses.

This is an optional regime applicable to entities which comply with all of the following:

- i) maximum turnover of € 200,000 in the previous year;
- ii) balance sheet not exceeding € 500,000 in the previous year;
- iii) are not statutorily subject to mandatory audit;
- iv) at least 80% of its share capital is held, directly or indirectly, by entities which fulfil the above mentioned requirements, except for venture capital companies or investors;
- v) adoption of the accounting regime applicable to micro-entities;
- vi) have not opted-out of the regime in any of the 3 previous years.

In accordance with this regime, the corporate income tax rate is applied on:

- i) 4% of the sales made in any industries and of the services rendered in the hotel and restaurant industry;

- ii) 75% of the income obtained by specific professional activities;
- iii) 10% of the remaining income obtained from the provision of services;
- iv) 95% of royalty income (as defined in the legislation), capital gains and other gains;
- v) 100% of other gains accrued gratuitously.

In order to provide for the additional costs incurred in by start-ups, the taxable basis referred to above is reduced in 50% and 25%, respectively, in the first and second years of activity.

Moreover, in order to simplify the taxation system of small enterprises, and cater for the specific difficulties of these entities, it is also foreseen that they are not subject to some of the autonomous taxation (*tributações autónomas*) rules or to the special payment on account.

IV. SIMPLIFICATION OF ANCILLARY TAX OBLIGATIONS

Acknowledging that the existing ancillary tax obligations pose an excessive compliance burden on taxpayers, thus discouraging investment in Portugal, Law no. 2/2014 cuts down some of the previously existing excessive red tape.

As compared to the previous version of the Corporate Income Tax Code, most of the

situations which required previous acceptance agreement by the tax authorities, in order to be put in place by the taxpayers, can now be completed subject to mere reporting obligations. Some of the areas where Law no. 2/2014 has impacted include, for instance, the procedure to adopt different depreciation rates, or to adopt a particular tax year.

In addition, the new Corporate Income Tax Code also simplifies some of the existing ancillary tax obligations, namely those concerning to the group taxation regime, the transfer pricing regime, the deduction of the tax losses regime, as well as the regime for the relief of economic double taxation.

V. REDUCTION OF TAX LITIGATION

Even though some improvements have been introduced in the tax judiciary system in Portugal in the past years, the length of tax litigation procedures is still a negative aspect of the Portuguese tax system.

In order to resolve some of the issues that traditionally give rise to massive litigation, Law no. 2/2014 puts forward a new concept of deductible costs for tax purposes as well as that of impairments due to bad debts, both purported to expand the concept in order to allow taxpayers to deduct, in general terms, all the costs incurred in their activities.

Another area of recurrent litigation is that of the application of double tax treaties, namely

regarding the requirement that the proof of residence in the other contracting State is submitted in a particular fashion. Considering the existing case-law it is now clarified that the other proofing methods shall also be accepted by the tax authorities, even though the existing procedure is preferable.

VI. HARMONIZATION OF ACCOUNTING AND TAXATION RULES

Another area that is a regular source of interpretation and application issues is that of the impact of the accounting rules in the taxation rules.

In fact, even though the taxable income of companies is based on the accounting result, the corporate income tax rules have traditionally introduced several distortions, which have now, to some extent, been abolished by adapting the tax rules to the accounting rules.

In particular, the concepts that are at stake in this situation are those of depreciations, impairments, provisions and intangible assets.

VII. DEFINITION OF A NEW INTERNATIONAL TAX POLICY AND THE NEW PARTICIPATION EXEMPTION REGIME

Bearing in mind one of the main goals of the reform – promote inbound and outbound

investment –, redefining the international tax policy is of the essence to achieve such objectives.

In this respect, in addition to the proposals of the Reform Commission regarding the negotiation of new double tax treaties and the renegotiation of existing ones in order to reposition Portugal in the current economic context, revising the tax rates applicable to non-residents and developing the introduction of anti-abuse measures in its double tax treaties (such as limitation on benefits clauses), Law no. 2/2014 introduces the long-discussed participation exemption regime, thus replacing the short-scoped holding regime.

Under this new regime, which qualifies as one of the most attractive in Europe, a participation exemption for dividends and capital gains is provided for in case of holdings of, at least, 5%.

However, unlike many of the participation exemptions regimes in Europe, the new regime has a broad scope of application which, together with the new patent-box regime, positions Portugal as a go-to platform for investments to and from Europe.

Moreover, a 5-year carry-forward period for international tax credits is introduced.

Additionally, to promote outbound investments, a new exemption regime is also introduced to income generated by foreign

permanent establishments of resident companies.

VIII. REDUCTION OF LIMITATION ON TAX LOSSES DEDUCTION

Another very important measure is that regarding the extension of the carry-forward period for tax losses.

Considering other existing regimes in Europe, Law no. 2/2014 extends the previous 5-year carry-forward period, to a 12-year period, which is a substantial benefit for companies operating in Portugal as compared to the previous regime.

Also worth of note is the clarification, and reduction, of the cases in which tax losses cannot be carried-forward. In this respect, a change in the entity's business is no longer an obstacle to tax losses carry-forward, nor is it a change in the holding structure as provided for in the Law.

IX. SIMPLIFICATION OF TRANSFER PRICING RULES

In order to ease the tax compliance burden on taxpayers, the threshold for the transfer pricing rules to apply has been raised.

As such, instead of the previous threshold of a 10% holding, the minimum holding for transfer pricing rules to apply is now set at 20%.

X. SIMPLIFICATION OF GROUP TAXATION RULES

On the other hand, Law no. 2/2014 reduces the threshold for eligibility for the group taxation regime already in place, while adapting the current regime to the case-law of the European Court of Justice.

In accordance, the eligibility holding threshold is reduced from 90% to 75%, thus allowing for the creation of taxable groups in more situations, which is deemed to be more in accordance with the economic reality.

On top of that, some penalties for non-communication of minor changes to the group were abolished, as they were considered to be excessive and inappropriate.

XI. SIMPLIFICATION OF THE TAX NEUTRALITY REGIME

As regards the tax neutrality regime, Law no. 2/2014 introduces a new list of operations covered by such regime.

In fact, in view of the current list of operations covered by the tax neutrality regime, several disputes have taken place as to whether or not similar operations that were not expressly

covered by the list could benefit from the regime.

In face of the long list of case-law on the matter, both from national courts as well as from the European Court of Justice, the list of operations covered, as provided for in the Corporate Income Tax Code, is broadened to include those operations which have already been analysed by said case-law, namely reverse mergers.

On the other hand, the regime applicable to reorganization operations (such as mergers or divisions) when the tax neutrality regime is not applicable is also clarified, thus solving interpretation problems that the previous regime entailed.

XII. CONCLUSIONS

As it can be seen from the analysis carried out above, the new Corporate Income Tax Code puts forward bold, although important, measures to promote the economic growth of the Portuguese market and of the Portuguese companies.

In accordance, and because of the new measures incorporated into the Corporate Income Tax Code by Law no. 2/2014, the Portuguese tax system is now a much more attractive one, ranking high as a holding jurisdiction, namely for investments to Europe and to the Portuguese-speaking world.

Lisbon, 27 January 2014

The logo consists of the letters 'RFF' in a bold, white, sans-serif font. The 'R' is on the left, and the two 'F's are to its right, with the first 'F' being significantly larger than the second.

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