



EUROPEAN TAXATION

Volume 54 - Number 2-3 - 2014

Articles

Denmark/European Union

- Exit Taxation within the European Union/European Economic Area – After *Commission v. Denmark* (C-261/11)

Germany

- The German Restructuring Privilege (Section 8c(1a) of the Corporate Income Tax Act) and the EU State Aid Rules (Article 107(1) of the TFEU)

International

- Tax Incentives: Ill-Advised Tax Policy or Growth Catalysts?

European Union

- Final Losses under EU Tax Law: Proposal for a Better Approach

Poland

- Transfer Tax Regulations in Poland

EU Update

CFE News

What's Going On In ...

Denmark; Germany; Portugal; Turkey; United Kingdom

International Aspects of the New Portuguese Corporate Income Tax Regime: Enhancing Tax Competition in the European Market

This note addresses the international aspects of the overhaul of the Portuguese corporate income tax regime undertaken by the Tax Reform Commission, which was re-published by Law 2/2014 of 16 January 2014. In particular, the note focuses on Portuguese international tax policy, namely the newly introduced participation exemption regime and the new regime applicable to income earned by foreign PEs of Portuguese companies.

1. Introduction

On the heels of the current economic crisis and of the bailout programme that is currently operational in Portugal, the *Troika* institutions,¹ as part of their sixth review of The Economic Adjustment Programme for Portugal, defined, as a top priority for Portugal, a comprehensive overhaul of the corporate income tax (CIT) regime in order to stimulate economic growth and foster both inbound and outbound investment.

Accordingly, the Portuguese government appointed a specialized Tax Reform Commission responsible for designing a comprehensive CIT reform, which resulted in the publication of Law 2/2014 on 16 January 2014 approving the corporate income tax reform and republishing the Corporate Income Tax Code.²

The reform project was of a comprehensive nature, ranging from the mere introduction of interpretative rules to the introduction of regimes that represent a complete novelty in the Portuguese tax scene.

One of the main areas of this reform is Portugal's international tax policy, both with regard to domestic legislation, as well as the negotiation of bilateral and multilateral tax related legal instruments, such as tax treaties and tax information exchange agreements.

As for Portugal's international tax policy with regard to international legal instruments, the Commission has put forward a series of recommendations that must be consid-

ered in any future negotiations or renegotiations of such instruments, most of which relate to the new legal regimes introduced in the domestic legislation, such as the participation exemption regime that will be discussed further herein.

The international aspects of the reform bring about a significant change in Portugal's position as a traditional supporter of the capital export neutrality principle, i.e. new regimes have been introduced that are typically associated with the capital import neutrality principle, thus favouring international investment to and from Portugal.

The two main features of this new policy are, in the authors' opinion, the new participation exemption regime and the new regime applicable to income earned by foreign permanent establishments (PEs) of Portuguese companies.

2. Elimination of Economic Double Taxation and the New Participation Exemption Regime

Portugal has traditionally adopted a semi-restrictive approach to the elimination of international economic double taxation.

In fact, the general regime previously in force was only applied to purely domestic cases, in an EU or EEA scenario³ (if certain requirements were met), or in relation to African Portuguese-speaking countries and East Timor, although it did not cover capital gains from the alienation of the relevant shares. In addition, there was also a holding regime that, although geographically broader, was only applied to pure holding companies (SGPS⁴ regime) and to capital gains on the disposal of shares.⁵

This being said, the new participation exemption regime constitutes one of the most interesting aspects of the reform, as it applies to dividend distributions, distributions of reserves and capital gains from the disposal of qualifying shares, irrespective of their origin, provided that the company in which the relevant shares are held is not resident in a tax haven.

In order for the regime to apply, the following requirements apply:

- there must be a direct or indirect holding of 5% or more of the share capital or of the voting rights;

3. The applicable rules cover both inbound and outbound dividends.

4. *Sociedades Gestoras de Participações Sociais*.

5. This regime also used to apply to dividends paid to pure holding companies in Portugal.

* Adv. LLM in International Taxation (Leiden) and tax lawyer at RFF & Associates (Lisbon). The author can be contacted at jcg@rfflawyers.com.

** Tax lawyer at RFF & Associates (Lisbon). The author can be contacted at jmp@rfflawyers.com.

The views expressed in this article are solely those of the authors.

1. International Monetary Fund, European Commission and European Central Bank.

2. PT: Income Tax Code, National Legislation IBFD.

- a minimum holding period of 24 months must be met;⁶
- the entity receiving the income (holding company) cannot be covered by the Portuguese tax transparency regime;
- the paying entity must be subject, without being exempt, to one of the CITs mentioned in the EU Parent-Subsidiary Directive (2011/96),⁷ or to a tax that is similar to the Portuguese CIT, at a nominal tax rate of 13.8% or higher;⁸ and
- the paying entity cannot be considered to be resident in a tax haven.

An interesting feature of this regime is that it does not include an alternative criterion for the minimum holding expressed in terms of the value, rather than percentage, of the holding, as is common in many other preferred holding jurisdictions.

This means that a smaller holding, for example, 2%, with a value of EUR 5 million, would not be covered by the participation exemption regime, thus making it, as compared to other such regimes, less attractive in this regard.

Moreover, and following recent recommendations of the OECD, an anti-abuse anti-mismatch rule aimed at preventing double non-taxation is also included, in order to prevent the application of this regime in situations where the payments give rise to a deduction or non-taxation in the source country.⁹

In order to avoid non-discrimination issues, the participation exemption regime has also been extended to Portuguese PEs of foreign companies to which dividends, reserves or capital gains are attributed.

However, interestingly enough, the PE regime only applies to companies that are resident in an EU Member State, in an EEA state or in a tax treaty partner country. In the latter two cases, such a state must have agreed to a level of administrative cooperation that is similar to that established in the European Union.

This means that in a situation where Portugal has concluded a tax treaty with a non-EU country that includes a non-discrimination rule with regard to PEs that is similar to that included in article 24(3) of the OECD Model

(2010),¹⁰ but does not include rules on administrative cooperation similar to those established in the European Union, a conflict may arise between the domestic legislation and the tax treaty. There is no easy solution to this problem. Any solution would require that, on the one hand, the participation exemption regime not be countered and, on the other hand, that the obligations of the relevant tax treaty be complied with.

Whenever the participation exemption regime is not applicable, namely because one or more of the requirements have not been met, Law 2/2014 foresees a new indirect tax credit regime, thus establishing a coherent and complete regime for the elimination of economic double taxation.

In order to close the circle and create a consolidated regime for inbound and outbound dividends, the new regime also includes a tax exemption for outbound dividends paid to EU companies, or to companies resident in an EEA state or in a tax treaty partner country. Again, in the two latter cases, such a state must have agreed to a level of administrative cooperation that is similar to that established in the European Union.

3. Domestic Tax Treatment of Foreign PEs

The new approach of the Portuguese tax regime to capital import neutrality is also reflected in the tax treatment of profits and losses incurred by foreign PEs of Portuguese companies.

The Portuguese CIT system is based on the worldwide taxation principle. Accordingly, all profits earned by a Portuguese company, irrespective of whether or not they arise in Portugal or abroad, are subject to tax therein, unless such tax competence is restricted under a tax treaty (either directly or through the application of the methods to eliminate double taxation).

This being said, and considering that PEs are not separate entities from their head offices, the previous tax regime required that all profits and losses attributable to a foreign PE of a Portuguese company should be included in the tax base of said Portuguese company.

Given that this may undermine cross-border investment by Portuguese companies, the new regime provides for the possibility of adopting the exemption method for the treatment of profits and losses obtained by foreign PEs.

In this regard, first, it is worth considering what the impact of this proposal may be on future negotiations, or renegotiations, of tax treaties. In fact, by granting such an exemption through its domestic legislation, rather than through its tax treaties, Portugal is forgoing a useful tool in the complex tax treaty negotiation process.

Nonetheless, one can obviously appreciate that the use of domestic legislation for these purposes is a much more effective and swift manner of providing Portuguese inves-

6. The holding period requirement must be met prior to the payment of the dividends, distribution of reserves or sale of shares. However, if the relevant shares have been held for a shorter period, the participation exemption regime still applies if the 24-month period is subsequently completed.

7. EU Parent-Subsidiary Directive – recast (2011/96): Council Directive of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), OJ L 345/8 (2011), EU Law IBFD.

8. The regime can still apply, even if this requirement is not met, if 75% or more of the relevant profits come from an agricultural or industrial activity in the country where the paying entity is based or from a commercial activity or from the provision of services, excluding financial services, which, in both cases, must not be targeted at the Portuguese market.

9. As stated in the recently published OECD Report, *Addressing Base Erosion and Profit Shifting*, pp. 15 and 16 (OECD 2013), International Organizations' Documentation IBFD, in addition to a need for increased transparency on effective tax rates of MNEs, key pressure areas include those related to international mismatches in entity and instrument characterization including hybrid mismatch arrangements and arbitrage.

10. OECD Model Tax Convention on Income and on Capital (22 July 2010), Models IBFD.

tors with a more equitable tax treatment in respect of their outbound investments.

Accordingly, this regime may apply if the taxpayer opts for it and if the following requirements are met:

- the profits attributable to the PE must be subject, without being exempt, to one of the CITs mentioned in the EU Parent-Subsidiary Directive (2011/96), or to a tax that is similar to the Portuguese CIT, at a nominal tax rate of 13.8% or higher; and
- the PE must not be located in a tax haven.

In the event this option is exercised, the regime applies to all PEs in a given jurisdiction and for a minimum period of three years.

Although some anti-abuse rules are also included in the regime, it allows for Portuguese companies to operate in foreign markets, namely those with a lower level of taxation, on the same level tax wise as local companies, thus facilitating such investments.

4. Other Proposals of International Relevance

Although this article only focuses on the international tax aspects of the CIT reform, there are other points of interest that may have an impact on a decision of a foreign investor to invest in Portugal or of a Portuguese investor to invest abroad.

In fact, the Commission has also proposed the progressive reduction of the nominal aggregated tax rate previously set at 31.5%¹¹ to an aggregated reduced rate of between 17% and 19% in 2016.¹²

As far as relief from international (juridical) double taxation is concerned, Portugal adopted a new regime to cal-

- 11. Aggregated marginal tax rate considering the additional national and municipal surtaxes.
- 12. For 2014, the non-aggregated statutory tax rate is reduced to 23%.

culate the amount of the foreign tax credit to be granted, moving from an overall approach to a per-country approach, which may result in higher unused foreign tax credits.

Finally, the amendments to the exit tax regime, which, following the ECJ's decision in *Commission v. Portugal* (Case C-38/10),¹³ push the Portuguese regime closer to European standards, provide for an effective tool to structure investments in Portugal, even more so considering the need to establish an appropriate exit strategy for the future.

5. Conclusions

Following this complete overhaul of the CIT regime, Portugal will certainly become a very interesting jurisdiction for cross-border investment and will compare favourably to other holding jurisdictions.

Although taxes are not the only consideration of investors, other factors being more or as decisive as the tax burden, the CIT reform, alongside the lower cost of incorporation in Portugal in comparison to other jurisdictions, and the unique tax arbitration regime,¹⁴ is expected to increase the level of foreign investment in Portugal and of Portuguese investment abroad, thus contributing to the economic growth of Portugal and to a long-term increase in state tax revenues, which is, in the end, the reason for putting this CIT reform in place.

- 13. PT: ECJ, 6 Sept. 2012, Case C-38/10, *Commission v. Portugal*, ECJ Case Law IBFD.
- 14. Tax arbitration was introduced in Portugal in 2011 and is a unique way of settling tax disputes between taxpayers and the tax authorities. Practice has shown that final decisions are issued within a six-month deadline after the claim is filed. The unique feature of this regime is that it is binding for the tax authorities, having the same effect as a decision issued by a (traditional) tax court.

For information about IBFD publications and activities
please visit our website at www.ibfd.org