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ENHANCING PORTUGUESE CORPORATE TAX REGIME

Draft report of the corporate Tax reform panel

The Corporate Tax (CIT) Reform Panel released its Draft Report on 30 July 2013.

The Panel was appointed by the Minister of Finance to consider options for reform, namely: (1) Promote simplification of the tax system by minimizing compliance costs for businesses. (2) Reevaluate nominal corporate tax rates. (3) Review certain tax incentives to promote investment, employment and competitiveness, with a particular emphasis on how these rules affect both Portuguese businesses investing abroad and foreign businesses investing in Portugal. (4) Develop practical and readily applicable changes, taking into account existing rules and tax treaties.

The Panel makes twenty-one (21) recommendations to improve several aspects of corporate tax system. The most relevant areas of potential legislative change for investors include:

- Gradual lowering over 5 years of the CIT rate.
- Changes to participation exemption regime, further enhancing portfolio investments held through Portuguese companies for both dividends and capital gains.
- Review of rules on the deductibility of financial expenses (interest barrier rule).
- Exemption method for foreign branch profits.
- Patent Box for qualified IP rights.
- Extension of loss carry-forward period and review of anti-loss trafficking rules.
- Review group taxation regime and rules applicable to reorganizations.

Each topic is discussed in more detail below.

1. GRADUAL LOWERING OVER 5 YEARS OF THE CIT RATE

Well aware that a phased reduction in CIT rate would be a sign that Portugal is open for business, but mindful of the potential budgetary implications under the current economical context, the Panel proposes 3 options for lowering the aggregate CIT rate.

The target on a 5-year spectrum is a nominal CIT rate within the first quartile of rates in force within the EU Member States (between 19% and 17%). The scenarios provide for a reduction already for 2014 of the CIT rate from 25% to 23% coupled with gradual reductions and eliminations of the surtaxes in the following years. This particular topic is expected to be comprehensively discussed during the consultation period.

2. ENHANCING THE PARTICIPATION EXEMPTION REGIME

This is yet another area where the panel whishes' to signal that is open for business, by setting a participation exemption for both dividends and capital gains that is competitive when positioned with other EU jurisdictions.

In basic terms, the Draft Report addresses both the income tax exemption for dividends and divestment gains received by a Portuguese company ("inbound") and withholding tax exemptions for distribution of dividends by a Portuguese company ("outbound").

- To qualify for the 100% exemption from dividends and divestment gains the Portuguese shareholder, the main criteria are: (i) 2% minimum shareholding on the company distributing the dividends. (ii) One-year holding period (may be satisfied after the income is derived). (iii) Not geographically limited (except for blacklisted jurisdictions). (iv) The company distributing the dividends is fully subject to income tax/profits tax comparable to the Portuguese corporate income tax and a minimum statutory income tax rate not lower than 10%.

- To qualify for the WHT exemption for dividend payments, the main criteria are: (i) 2% minimum shareholding on the company distributing the dividends. (ii) One-year holding period (may be satisfied after the income is paid). (iii) Geographically limited to shareholders resident in a EU Member State, EEA (excluding those that do not exchange tax information with Portugal) or jurisdiction with which Portugal has signed a DTA with exchange of information mechanism. (iv) Company receiving the dividends should be fully subject to income tax/profits tax comparable to the Portuguese corporate income tax and a minimum statutory income tax rate not lower than 10%.

Measures also include rules to extend the participation exemption rules to permanent establishments.

The proposed changes include revoking the specific Portuguese holding companies regime (SGPS). No changes are proposed to the domestic exemption on capital gains derived by non-residents from the sale of shares in Portuguese companies, which continues to broadly exempt non-residents unless gains derived relate directly or indirectly from shares in resident companies whose assets consist in more than 50% of Portuguese-situs real estate property.

3. REVIEW OF THE INTEREST BARRIER RULE

The last Budget Law enacted a major change by replacing the old thin-capitalization rules (2:1 debt-to-equity ratio – only applicable to non-EU-resident lenders) by an interest barrier rule which limits the deductibility of net financial expenses to the higher of the following: (i) €3m. Or (ii) 30% of EBITDA (operating profits before interest, taxes, depreciations and amortizations). This measure was coupled by an important phase-in provision according to which the EBITDA limit will be 70% in 2013, 60% in 2014, 50% in 2015, 40% in 2016 and only 30% as from 2017 onwards.

The Draft Report proposes: (i) A reduction of the first barrier to €1 million (from the €3 million). (ii) Certain accounting adjustments to the calculation of the EBITDA (currently determined in accordance with Portuguese accounting rules). (iii) Include rules for thresholds to be calculated at the level of entities taxed as part of a tax group (as today the limits are computed at individual level).

4. EXEMPTION METHOD FOR FOREIGN BRANCH PROFITS

The Panel proposes an elective regime for exemption of foreign branch profits as a measure to ensure greater alignment between the taxation of foreign branches and foreign subsidiaries and increase competiveness of Portuguese businesses investing abroad.

Under the present rules, Portuguese companies are subject to CIT on the profits of their foreign branches, with credit given for foreign tax paid on those profits to relieve double taxation. In cases where the foreign tax paid is less than the Portuguese tax, then the company must pay a “top-up” of Portuguese CIT tax, while under an exemption regime there would be no such (additional) tax. The corollary of exempting foreign profits from taxation is that foreign branch losses would no longer be relievable. Specific recapture rules are also included on the Draft Report.

5. PATENT BOX FOR QUALIFYING IP RIGHTS

The Patent Box provides a partial exemption (50%) from CIT for companies exploiting patented inventions and other innovations such as models and industrial designs protected by intellectual property (IP) rights. The partial exemption applies to a proportion of the profits derived from both the licensing and sale of the qualifying IP rights. In addition, the 50% exemption applies on gross income, so costs incurred in the development of the qualifying IP rights remain fully deductible.

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Amongst the requirements to apply are: (i) qualifying IP must be self-developed. (ii) the licensee cannot be resident of a blacklisted jurisdiction. (iii) the IP must be effectively used for business activities. (iv) if the licensee is a related company, the IP cannot be used to create deductible expenses for the taxpayer.

The Panel also proposes that the acquisition cost incurred with certain intangible assets with unlimited-life (acquired after 1 January 2014) may be tax deductible at a 5% rate over 20 years.

6. EXTENSION OF LOSS CARRY-FORWARD PERIOD

The Budget Law for 2012 extended the loss carry-forward period from four to five years but on the other hand included a limitation of the yearly amount deductible to 75% of the taxable profits.

In line with other EU countries, the Panel proposes to extend to 15 years the carry-forward period for losses originated as from 1 January 2014. The offsettable losses will remain limited to 75% of the taxable profit of the year. The Panel also proposes to lower the cases where an "ownership change" is deemed to occur for purposes of the anti-loss trafficking rules.

7. GROUP TAXATION REGIME AND REORGANIZATIONS

The Panel also proposes several changes to the group taxation regime and to the rules applicable to reorganizations that streamline the rules and facilitate the operation of groups. The proposed changes include: (i) Reduction to 75% shareholding the threshold to apply for group taxation. (ii) Extension of the regime to "sandwich" groups (lower tier Portuguese entities held by a foreign entity held by a Portuguese entity). (iii) Streamline of the beginning, termination and modifications to the tax group. (iv) Revamp the tax neutrality rules for corporate reorganizations. (v) set out express rules for taxable reorganizations. (vi) Elimination of pre-request to transfer losses in the framework of reorganizations.

8. OTHER RECOMMENDED MEASURES

In addition to the topics above, the Panel recommendations include: (i) A new simplified regime for small enterprises. (ii) Revamp of the rules on deductible and non-deductible expenses incurred by the taxpayer. (iii) Increase to 20% the related party threshold and from € 3m to € 5m of net sales or revenues the requirement for contemporaneous transfer pricing documentation. (iv) Streamline treaty-relief documentation. (v) Review certain tax incentives and international tax policy.

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NEXT STEPS

The Panel recommendations are intended to modernize further the Portuguese corporate tax system bringing into ranks with tax systems in other jurisdictions and reflect changes in the global landscape.

The release of the Draft Report will be followed by a public consultation up until the end of September. It is expected that the final reform proposals will integrate a Bill to be delivered to the Parliament by the end of October 2013. Following discussion and approval of the measures, the proposals are expected to enter into force as from 1 January 2014.

Garrigues will be involved on the public consultation and is open to discuss with you your contributions to the ongoing debate and/or the potential impact of the proposed measures on your business.

For more information or if you wish discuss in detail any issues related to this alert, please contact your local Garrigues professionals:

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