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Portugal – Corporate Income Tax Reform, Budget Law for 2014 and Amendments to the Budget Law for 2013:
Main tax features.

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Introduction

Law no. 2/2014, of 16 January, which approved the reform of the Corporate Income Tax (the "**CIT Reform**"), entered into force yesterday (21 January 2014), completing a significant overhaul of the Portuguese tax system initiated by the recent Laws no. 83/2013, of 9 December, amending the Budget Law for 2013 (the "**2013 Amendments**") and no. 83-C/2013, of 31 December, which approved the Budget Law for 2014 (the "**2014 Budget**") .

This newsletter summarises the changes to the Portuguese tax system arising from these laws that are more likely to affect foreign entities investing and trading in Portugal.

Corporate Income Tax

Reduction of CIT rate

The CIT Reform reduces the CIT rate to 23% for 2014. Depending on the assessment by a commission which will monitor the progress of the changes to the CIT, this rate is set to drop to 21% in 2015 and to a figure between 17% and 19% in 2016.

Additionally, for small and medium-sized companies (as per the European Union – "**EU**" law definition) a CIT rate of 17% will apply to the first Euros 15,000 of their taxable profit. The portion of the taxable profit which exceeds Euros 15,000 is subject to the general CIT rate of 23%.

The CIT Reform establishes a new tier of State Surcharge, the rate of which is 7%, applicable to the portion of the taxable profit which exceeds Euros 35 million. The remaining rates remain unchanged: 3% (taxable profit in excess of Euros 1.5 million and up to Euros 7.5 million) and 5% (taxable profit in excess of Euros 7.5 million and up to Euros 35 million).

Tax losses carry-forward regime

The CIT Reform extends the tax losses carry-forward period from 5 (five) to 12 (twelve) years. Additionally, the deduction cap is to be reduced to 70%

(previously tax losses could offset up to 75% of the taxable profits of the year).

Furthermore, the changes to the company's object clause or to the company's main activity cease to cause the expiry of the tax losses. The CIT Reform establishes that a change of ownership corresponding to, at least, 50% of the share capital or of the voting rights continues to trigger such expiry but with a significant restriction to the concept of "change of ownership" with a view to facilitate reorganisations and other "non-abusive" transactions. Specifically, the following situations will no longer represent a "change of ownership":

> substitution of direct ownership of share capital or voting rights for indirect ownership of such corporate rights and vice-versa;

> changes of ownership resulting from CIT neutral reorganisations or from inheritance;

> increase of shareholdings by (i) holders of more than 20% of the share capital or of the majority of the voting rights for an uninterrupted period of one year, or (ii) by employees or members of statutory bodies, in either case by reference to the end of the tax year to which the losses and the change in the ownership of capital relate to.

The new regime is only applicable to tax losses generated in tax years beginning on or after 1 January 2014.

Participation exemption

One of the more innovative regimes set forth in the CIT Reform consists of a very significant broadening of the "participation exemption" regime, rendering Portugal a more attractive investment platform within the EU.

According to said regime:

> distributed profits and reserves, as well as the reimbursements resulting from the cancellation of shares without reduction of share capital, in favour of any CIT taxable entity with head office or place of effective management in the Portuguese territory (the "**Portuguese taxable entity**"); and

> capital gains and losses arising from the disposal of corporate rights or other equity instruments associated to those rights,

shall not be considered for purposes of assessing the taxable result, provided that the following cumulative conditions are met:

> the Portuguese taxable entity holds, uninterruptedly, during the 24 months prior to the distribution (or, if held for less time, until said 24 months period elapses) or alienation, as applicable, at least 5% of the share capital or voting rights of the entity (i) which distributed the profits or the reserves or whose shares were cancelled, or (ii) whose corporate rights or other equity instruments associated to those rights have been disposed of;

> the Portuguese taxable entity is not subject to the tax transparency regime;

> the entity (i) which distributed the profits or the reserves or whose shares were cancelled, or (ii) whose corporate rights or other equity instruments associated to those rights have been disposed of, is subject to (and not exempt from) CIT, or to gambling tax, or to one of the taxes listed in Annex I, Part B of Directive no. 2011/96/EU, September 30th (the "**Parent-Subsidiary Directive**"), or to a similar tax the rate of which is not lower than 60% of the CIT rate. However, this criterion may be alternatively fulfilled if certain conditions relating to the nature of the activity or of the assets of the subsidiary are met (in broad terms, if assets and activities are not mostly of a passive nature);

> the entity (i) which distributed the profits or the reserves or whose shares were cancelled, or (ii) whose corporate rights or other equity instruments associated to those rights have been disposed of, is not resident in a tax-privileged jurisdiction included in a list approved by the Minister of Finance ("**blacklisted jurisdiction**");

> the profits or the reserves distributed by the subsidiary cannot be considered as deductible expenses for purposes of the relevant tax applicable to such subsidiary (in order to avoid double non-taxation).

The holding period already elapsed at the date of entry into force of the CIT Reform is taken into consideration for purposes of computing the above--mentioned period of 24 months.

Exceptionally, capital gains and losses arising from the disposal for consideration of shares in companies whose real estate or rights *in rem* in immovable property within Portugal (except for real estate assets allocated to a commercial, industrial or agricultural activity other than a purchase and sale of real estate assets activity) represent, directly or indirectly, more than 50% of their assets, are not excluded for purposes of determining the taxable result. This exception only applies to real estate assets or rights *in rem* in immovable property acquired from, and including, 1 January 2014 onwards.

With respect to outbound dividends, profits and reserves that a Portuguese tax resident entity – subject to (and not exempt from) CIT or to gambling tax and not subject to the tax transparency regime – distributes to a non-resident entity are exempt from CIT, as long as the beneficiary:

> is resident (i) in an EU Member State, (ii) in an European Economic Area ("**EEA**") Member State bound to administrative cooperation in tax matters equivalent to that in force in the EU, or (iii) in a State with which Portugal has a Double Taxation Convention in force which provides for administrative cooperation in tax matters equivalent to that in force in the EU);

> is subject to (and not exempt from) one of the taxes listed in Annex I, Part B of the Parent-Subsidiary Directive, or to a similar tax, the rate of which is not lower than 60% of the CIT rate; and

> holds, uninterruptedly, during the 24 months prior to the distribution (or, if held for less time, until said 24 months period elapses), at least 5% of the share capital or voting rights of the entity which distributed the profits or the reserves.

This regime is also applicable when the profits and reserves are distributed to a permanent establishment located in an EU Member State, or in an EEA Member State (provided in the latter case that such jurisdiction complies with its obligations of administrative cooperation and mutual assistance in recovery of claims), as long as the head-office of said permanent establishment fulfils the abovementioned conditions.

As a consequence of this participation exemption regime, several tax regimes become redundant and are repealed, notably:

> the special tax regime for pure Holding Companies (with legal status of "**SGPS**") and the participation exemption for Venture Capital Companies and Business Angels. The withholding tax exemption in relation to interest received by SGPS from its subsidiaries is extended to interest and other types of income from shareholder loans, commercial paper and bonds derived by any Portuguese resident entities subject to CIT having held more than 10% of the share capital with voting rights (directly, or indirectly through controlled companies) of the debtor for at least one year prior to said income becoming available;

> the regime of elimination of double taxation of profits received from Portuguese-Speaking African Countries or East Timor;

> the regime of reduced taxation on capital gains in case of reinvestment of the amount received (in what concerns shares).

As regards the taxation of shareholders upon the liquidation of subsidiaries on the positive difference between the liquidation proceeds and the cost of acquisition of share capital and other equity instruments, the CIT Reform eliminates the current segregation between capital gains (the portion between the cost of acquisition up to the par value, where the equity is purchased below par) and investment income (the portion exceeding the par value).Said positive difference is now to be classified as a capital gain.

The CIT Reform introduces an underlying tax credit in order to eliminate international double economic taxation (that is, the underlying tax borne abroad by subsidiaries of the non-resident direct subsidiary), at the taxpayer option, in case the participation exemption criterion referring to the nature and amount of income tax borne by the subsidiaries is not met (the percentage, the minimum holding period and the residence in a non-blacklisted jurisdiction

criteria are common to both the participation exemption and the underlying tax credit regimes).

As regards international juridical double taxation, the CIT Reform reinstates the ability to carry forward, for five years, the portion of international tax credit which exceeds the tax liability in respect of such foreign income of a given tax year and thus cannot be immediately credited.

Lastly, the CIT Reform imposes FIFO (First In First Out) for ascertaining the holding period upon a disposal of shares of the same nature and providing similar voting rights.

Results generated by foreign permanent establishments

According to the CIT Reform, any Portuguese taxable entity may opt for disregarding profits and losses generated by its permanent establishments located outside Portugal. The option depends on the fulfilment of conditions similar to the ones applicable to the participation exemption regime (in broad terms, the permanent establishment cannot be located in a blacklisted jurisdiction and its profits must be subject to a tax similar to the CIT, the rate of which is not lower than 60% of the CIT rate). The taxable profit of the Portuguese taxable entity shall reflect the results of the internal dealings carried out with the permanent establishments as if head-office and permanent establishment were independent companies. The Portuguese taxable entity cannot disregard profits of the permanent establishment up to the amount of losses used to offset its own profits in the 12 years prior to the option; if the regime ceases to apply, losses generated from that date onwards by the permanent establishment can only offset taxable profits of the head-office when they exceed the profits of the permanent establishment generated in the previous 12 years which were disregarded due to the application of the regime. In case of a permanent establishment ceases its activity, the CIT Reform does not provide for the ability to recover losses not previously used by the permanent establishment, which may be in breach of EU law in light of the decision of the Court of Justice in *Lidl Belgium GmbH & Co. KG* (C-414/06).

Limitation to the deductibility of net financing costs

According to the CIT Reform, the regime of limitation to the deductibility of net financing costs introduced in 2013 will be subject to several amendments:

- the fixed safe-haven of Euros 3 million of net financing costs is reduced to Euros 1 million (the alternative cap of a percentage of the EBITDA is maintained, being reduced by 10 percentage points each year, from 70% in 2013 to 30% from 2017 onwards);
- the definition of EBITDA for the purposes of this rule is restricted so as to disregarding several items, namely income and gains not taxed under the participation exemption regime (and the corresponding costs and losses under the same circumstances) and the energy sector contribution;

> upon election of the parent company, the regime may apply on a consolidated basis to groups subject to the special tax grouping regime;

> the list of entities explicitly excluded from regime will include securitisation companies.

Exit tax

With the CIT Reform, the Portuguese regime is now closer to others adopted within the EU and broadly complies with the case-law of Court of Justice, in particular with the decision on *Commission v Portugal* (C-38/10).

According to the CIT Reform rules, if a Portuguese taxable entity transfers its seat or place of effective management to an EU or an EEA Member State (provided in the latter case that there is exchange of tax information and mutual assistance in recovery of tax claims – "**qualifying EEA jurisdiction**"), the exit tax may be paid as follows:

> Immediately, for its total amount, as calculated pursuant to the last annual CIT return;

> Up to an year after the extinction, transmission or transfer of the assets, for any reason, to a jurisdiction that is a EU Member State or a qualifying EEA jurisdiction (we believe that this wording goes beyond what was intended, because it appears to indicate that the taxpayer would not be taxed, on the portion of the gain attributable to the period where it was a Portuguese taxable entity, in case of a disposal of its assets to another EU Member State or qualifying EEA jurisdiction); or

> In annual instalments of 1/5 of the tax due, counting from the tax year of the transfer of seat or place of effective management.

If the taxpayer chooses any of the deferred payment methods abovementioned, interest will be due and, depending on an assessment of the risk of default by the migrant entity, a guarantee in favour of the Portuguese Tax Authorities may be required.

Tax benefit for the reinvestment of retained earnings

The 2014 Budget sets out a new tax benefit regime for small and medium-sized companies (as per the EU law definition): an amount corresponding to up to 10% of the retained earnings which are reinvested in eligible assets within two years counting from the tax year they are generated is deductible against up to 25% of the annual CIT liability, with a cap of Euros 5 million.

The eligible assets include in general all new tangible fixed assets, excluding items such as land, constructions, acquisitions, repairs and expansion of buildings – unless they are related to administrative or productive activities –, as well as light passenger or mixed-use vehicles, among others.

Share capital remuneration regime

The CIT Reform introduces another tax benefit regime for small and medium-sized companies (as per the EU law definition): the share capital

remuneration regime. Under this regime an amount corresponding to 5% of the equity capital paid in by the shareholders for incorporation of a company or for increasing the share capital that company is deductible from the annual CIT liability, with a cap of Euros 200,000 for a period of three years and under the limits set forth in the Regulation (EEC) no. 1998/2006, of the European Commission, of 15 December.

The deduction can be made in relation to the CIT liability of the tax year in which the equity capital was paid in or in the next three tax years, rule which is ambiguous as this regime is not introduced in the CIT Code, suggesting its application only to the 2014 year (unless this regime is maintained by subsequent laws).

"Patent box" regime and goodwill

Under the CIT Reform, income resulting from patents and other industrial property rights subject to registration are subject to a special tax regime. According to said regime income resulting from the assignment or concession of temporary use of patents and industrial models or designs, as well as from the breach of these rights, shall be considered for only half of its value for purposes of determining the taxable profits (thus giving rise to an effective CIT rate of as low as 11.5% in 2014 and 8.5% to 9.5% in 2018).

This regime is applicable provided that the following cumulative conditions are met:

- the industrial property rights have resulted from research and development activities undertaken or contracted by the Portuguese taxable entity;
- the assignee uses the industrial property rights in a commercial, industrial or agricultural activity;
- the output of the use of said industrial property rights by the assignee does not materialize in the delivery of goods or services that generate tax losses deductible by the assignor (or by a company included in the same taxing group of the assignor), whenever the assignor (or such group company) have a special relation with the assignee;
- the assignee is not resident in a blacklisted jurisdiction.

This regime does not apply to income arising from accessory services to the assignment or temporary use agreements.

Moreover, the CIT Reform establishes the depreciation in twenty tax years of industrial property elements which do not have a limited useful life and of goodwill (other than financial goodwill), acquired in the context of reorganisations of companies which do not avail of the tax neutrality regime.

CIT and PIT: Debt securities regime

The 2013 Amendments sets forth the expansion of the scope of the special taxation regime applicable to income arising from debt securities (basically providing for a full withholding tax exemption as well for an exemption from

tax on capital gains) to central securities systems other than the Portuguese Interbolsa and to a wider range of securities, including short-term financial instruments (such as commercial paper and treasury bonds).

Under the 2013 Amendments the personal scope of the debt securities regime suffered several changes, in particular:

> non-resident entities which are more than 20% held, either directly or indirectly, by Portuguese resident entities are no longer excluded from the exemption;

> investors deemed resident for tax purposes in countries with whom Portugal has concluded (i) a Double Taxation Convention or (ii) a tax information exchange agreement will be eligible for this regime, irrespective of whether they are located in a blacklisted jurisdiction.

These changes to the debt securities regime have some specificities regarding their temporal application. In fact, the changes entered into force on 10 December 2013 and are only applicable to debt issued after 31 December 2013 or income earned after the first coupon due in 2014, for debt issued before 31 December 2013. Changes made to the scope of the debt securities that avail of the debt securities regime (e.g. commercial paper) are retroactively applicable to securities issued after the 1 January 2013.

The extension of the personal scope of the debt securities regime will only be applicable after the first coupon that becomes due in 2014 (or after, if no coupon becomes due throughout 2014), since only after that date are the direct registering entities bound by the new compliance rules set forth under the debt securities regime.

Other relevant tax features

> The CIT Reform relaxes formalities to avail of relief under Double Taxation Conventions (residence certificates issued by the foreign tax authorities will suffice);

> Exemption of CIT for gains obtained by non-resident credit institutions in relation to repos of securities with Portuguese credit institutions, provided that the gains are not attributable to a permanent establishment in Portuguese territory;

> Exemption of Stamp Duty for repos of securities or equivalent rights carried out on a stock exchange, as well as for repos and assignments by way of security by financial institutions and intermediated by central counterparties;

> The Madeira Free Zone regime currently in force (until 2020) for companies licensed until 31 December 2013 may apply to companies which are licensed up to, and including, 30 June 2014. This is in line with the European Commission decision of 26 November 2013 in which the Commission gave clearance to the extension of this regional aid scheme whilst the Government prepares a new regime for companies licensed from 1 July 2014 onwards;

> In the meantime, the 2013 Amendments also aligns the Madeira Free Zone regime with the Decision of the European Commission of 2 July 2013, increasing by 36,7% the thresholds of the brackets of taxable profit which may avail of the reduced 5% CIT rate.

The 2014 Budget also authorises the Government to review the tax framework of Undertakings for Collective Investment in Transferable Securities (which may become generally transparent but subject to a 0.01% to 0.2% Stamp Tax on net assets) and to introduce a regime of withholding tax exemption for interest payable to credit institutions resident within the EU or qualifying EEA jurisdictions.

Energy Sector Contribution

The 2014 Budget introduces a new contribution for the energy sector. Under this regime, several entities operating in the Portuguese energy sector will be subject to a 0.85% contribution (there are exceptions subject to a different rate: 0.285% or 0.565%) over their tangible and intangible fixed assets except industrial property rights) and financial assets allocated to activities carried on through a concession or license. In broad terms, entities carrying on activities connected with renewable energy are generally not subject to this regime. This new contribution is not deductible for purposes of determining taxable profits for CIT purposes and is aimed to setting out a fund aimed at providing sustainability to the energy sector.

Stamp Duty

The 2014 Budget extends the scope of the one-year exemption of stamp duty applicable to short-term financing and associated interest by SGPS and Venture Capital Companies to short-term financing and associated interest when loans are granted by any companies in favour of subsidiaries held in at least 10% of the share capital with voting rights, or the acquisition value of which was not less than Euros 5 million (according to the last balance sheet), or granted in favour of companies which are in a controlling or group relationship as per corporate law rules.

Entry into force

The 2013 Amendments entered into force on 10 December 2013 and the 2014 Budget entered into force on 1 January 2014, in both cases on the day following the respective publication in the Official Gazette.

The CIT Reform does not have any provision regarding its entry into force, thus the general *vacation legis* rule of five days shall apply, which means that the CIT Reform only entered into force on 21 January 2014.

Nevertheless, the CIT Reform sets forth that it shall apply to the taxable periods starting on or after 1 January 2014 or to taxable events occurred from that date onwards. This cannot apply however to all the instantaneous taxable events occurred prior to the date of its entry into force (21 January 2014), as such an application of the law would not comply with the Portuguese Constitutional principles, such as the principle prohibiting the retroactivity of substantive tax rules.

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