Tax Flash

CIT Reform Proposal

Cornerstones of this reform: simplification of tax compliance obligations, reduction of tax disputes, as well as a the intention to progressively reduce the corporate income tax rate, along with proposed changes to the participation exemption and group taxation regimes, taxation of intangibles, and carry forward of tax losses and tax credits.

The proposal to reform Corporate Income Tax was approved by the Council of Ministers and the respective Law was submitted to the Portuguese Parliament on 14 October 2013.

The Law shall be applicable to tax periods starting, or taxable events occurring, on or after 1 January 2014.

Tax transparency regime

- The regime has been extended to the income from partnerships where more than 75% derives from professional activities. There cannot be more than 5 Partners and 75% of the share capital must be held by professionals performing their activities through the partnership).

Periods for taxable profit

- Income, costs and other equity variations deriving from the proportional consolidation method are disregarded for the purposes of the calculation of the taxable profit of collective enterprises liable to CIT.
- Fair value variations of equity instruments, the price of which is determined by a regulated market, are relevant for tax purposes in case of a shareholding below 5%.

Subsidies – New rules for inclusion in taxable profit

- Intangible assets without a determined lifecycle: 20 years, irrespective of whether received.
- Investment properties valuated at fair value: throughout the maximum period of useful life, irrespective of whether received.
- Non-consumable biological assets valued at fair value: throughout the maximum period of useful life, irrespective of whether received.

Tax deductibility of costs and losses

- Deductibility of costs shall no longer be determined by the respective business need; however, costs and losses must be incurred to obtain income liable to CIT.
- Documents supporting the acquisition of goods or services must include at least the following elements: (i) name of seller and acquirer, (ii) tax number of both entities if resident in Portugal, (iii) quantity and commercial denomination of acquired goods or services, (iv) price and (v) date of acquisition.
- When VAT rules require the issuance of an invoice, this shall be the supporting document required.

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Construction Contracts

- Nil profit method shall be relevant for tax purposes when the closing of a construction contract cannot be accurately estimated.

Non-deductible costs

- Autonomous taxation.
- Costs for which the supporting documents do not fulfill the new legal requirements.
- Interest on late payments.
- Taxes and other duties due by third parties for which the taxpayer is not legally responsible.
- Capital losses and other losses relating to equity instruments, on the amount corresponding to capital gains and profits that, in the taxable period or in the previous 4 tax periods, have benefited from the participation exemption regime or from a tax credit to eliminate cross-border economic double taxation.

Losses for credit impairments

- Late payment interest on commercial debts shall be considered for the purposes of the computation of the value of tax deductible impairment losses regarding credits deriving from normal commercial activity.
- Situations where the risk of collection of credits is considered to exist: (i) Tax execution; (ii) insolvency; (iii) company's revitalization or recovery extra judicial procedures (under SIREVE).
- The following are not regarded as bad debts: (i) credits over individuals or companies holding, directly or indirectly, more than 10% of share capital and (ii) companies held, directly or indirectly, in more than 10%.

Non-collectable credits

- Tax deductibility no longer depends on the communication to the debtor that the cost has been deducted for tax purposes.

Depreciation and Amortization

- Request for the use of different methods other than "straight line method" and "decreasing quota method" needs to be filed before the end of the tax period in which the change should occur.
- In order to determine the depreciation or amortization value, the expenses related to the removal of the asset are not taken into consideration. In addition, the residual value is deducted.
- Components, major repairs and improvements depreciation rates are calculated according to the expected useful life.
- Trademarks, licences, manufacturing processes, models or other similar rights that have been acquired for a consideration and do not have a pre-determined lifecycle, as well as goodwill resulting from a restructuring (except (i) if the tax neutrality regime is applicable or (ii) assets acquired from entities subject to a more favourable tax regime or (iii) goodwill referring to shareholdings) may be tax depreciated for a 20 year period. This rule only applies to assets acquired on or after 1 January 2014.
- Investment properties and non-consumable biological assets valued at fair value may be tax depreciated throughout the maximum period of the useful lifetime of the asset. Since no transitory regime has been created in this respect, this rule will also apply to assets acquired before 2014.

Social expenses

- Health insurance contracts benefiting employees' relatives are subject to the same regime as the contracts benefiting employees.

Capital gains and capital losses

- The concept of transactions for a consideration is broadened to include: (i) extinction and amortization of shareholdings with reduction of share capital and (ii) the extinction of a participation through reduction of share capital with the purpose of compensating losses of a company when the respective shareholder, after the extinction, is no longer a shareholder of such company.
- Evaluation of sales of share capital is determined according to FIFO. The taxpayer may opt for the average cost method; however, this option is mandatory for a minimum 3 year period and the monetary devaluation coefficients shall not apply.
- Reinvestment regime shall also apply to intangible assets, but it is no longer applicable to investment properties.
- Reinvestment regime regarding participations in share capital is revoked.

Taxation of outbound reserves and dividends

- Exemption applies to shareholdings of 5% and above (presently 10%).
- Profits and reserves placed at the disposal of a non-resident entity which is resident of a state with which Portugal has a double taxation agreement (foreseeing administrative cooperation in tax matters equivalent to the one which is in force within the EU) are tax exempt provided that the above mentioned minimum holding percentage requirement is met and the beneficiary entity is subject in its State of residence to tax at a legal rate not lower 60% of the Portuguese standard CIT rate.

Participation exemption for dividends, reserves, capital gains and capital losses

- Applicable to shareholdings of 5% or more, where dividends are held for a 12 month period (which may be complied with afterwards).
- Regime requires that entity distributing profits is subject to and not exempt from (i) Portuguese CIT or (ii) similar tax referred to in the Parent-Subsidiary Directive or (iii) similar tax provided that the applicable legal rate is not lower than 60% of the Portuguese standard CIT rate.
- Such requirement is not mandatory when: (i) at least 75% of the profits derive from an agricultural, industrial or commercial activity, or from the rendering of services, which are not predominantly targeted to the Portuguese market; (ii) the activity of the non-resident entity does not generate passive income; (iii) the entity distributing the profits or the reserves or which shareholdings are sold does not have residence or is domiciled in a jurisdiction with a more favorable tax regime.
- Regime is not applicable to profits or reserves that qualify as deductible costs in the distributing entity.
- Proof of compliance with requirements of the regime does not imply specific formalities.
- Regime is also applicable to the sale of shareholdings and other equity instruments within non-tax neutral restructurings.
- Regime is not applicable to the sale of shareholdings in case the value of real estate, directly or indirectly, represents more than 50% of the assets (except immovable property allocated to an agricultural, industrial or commercial activity excluding the rental, acquisition and sale of immovable property).
- Regime is applicable to capital gains realised before 1 January 2001 which taxation is suspended.

Profits and losses of foreign permanent establishment

- Optional regime for the exclusion of profits and losses of a foreign permanent establishment on the computation of the taxpayer's taxable profit, subject to requirements being met.
- Optional regime is not applicable to profits of the foreign permanent establishment up to the same amount of losses of the same foreign permanent establishment which have been considered for the computation of the taxpayer's taxable profit in the previous 12 taxation periods.
- Optional regime shall apply, at least, to all permanent establishments located in the same jurisdiction, and is mandatory for 3 years as of the date in which the regime starts to apply.

Non-resident entities – Profits attributable to a permanent establishment

- General administration costs, valued at arm's length, are accepted.
- Such costs are no longer determined according to the partition criteria and limits accepted by the Tax Authorities.

Tax losses

- Tax loss carry forward period is extended from 5 to 12 tax periods (applicable only for losses generated as of 1 January 2014).
- Tax losses carried forward may be deducted up to 70% of the taxable profit (currently 75%).
- Tax losses shall be deducted according to FIFO.
- Change to statutory object or substantial change of activity no longer determines the loss of tax losses carried forward.
- Change of the ownership of at least 50% of share capital or of the voting rights continues implying the loss of tax losses carried forward. However, the following situations do not qualify as such:
  - Changes from direct to indirect ownership (and the reverse), as well as those resulting from restructurings and inheritances by death;
  - When the acquirer holds continuously, directly or indirectly, more than 20% of share capital or the majority of the voting rights of the company as of the tax period in which the losses were generated; or
  - When the acquirer is an employee or director of the company as of the tax period in which the losses were generated.

CFC

- The threshold for the application of CFC rules is changed from 60% of the tax that would be due if the non-resident entity would be resident in Portugal to 60% of the Portuguese nominal standard CIT rate.
- Entities resident in more favourable tax regimes where the main activity consists of transactions involving participations of more than 5% of the share capital or of the voting rights are outside the scope of CFC rules.

Reduction of share capital

- There is only taxable income when the amount paid to the shareholders exceeds the acquisition value of the shareholdings.

Own shares

- Results deriving from transactions of own shares are not relevant for tax purposes.

Tax neutrality regime

- Clarification that the regime is applicable to mergers and spin-offs of companies held by the same shareholder, even when there is no exchange of shares, as well as to reverse mergers.
- Capital gains or losses resulting from the annulment of shareholdings of the merged company are not relevant for the computation of the taxable profit of the beneficiary company.
- There is a new set of rules for the determination of tax value of shareholdings of companies subject to mergers or spin offs when there is no allocation of shares as a result of neutral reorganizations.
- Tax losses of merged companies may be transmitted to the beneficiary company.
- Tax benefits and balances deriving from the limitation of the deductibility of net financing costs may be transmitted from the merged company to the beneficiary company.
- The same possibility may be extended to spin-offs and assets contributions under of governmental authorization.

Mergers, spin-offs, capital contributions or exchange of shareholdings

- When the tax neutrality regime is not applicable, there is no taxable event at the level of the beneficiary entity (equity variation is not relevant for tax purposes), but instead only at the level of the contributing company.
- Regarding the resulting income, even if qualified as a capital gain, there is no possibility of applying the reinvestment regime.

Liquidation of companies

- Liquidation proceedings are considered capital gains or capital losses.
- The capital gain is taxable, except if the participation exemption regime is applicable, while the capital loss shall be fully deductible if the participation is held for four years or more.
- For the computation of the liquidation proceedings, other equity instruments shall be considered part of the relevant acquisition value.

Exit tax – Transfer of residence

- The transfer of residence of a Portuguese resident company shall be subject to exit tax, but the tax liability can be deferred in case the transfer is made to a EU or EEA member state provided that certain conditions are met.
- This regime shall not be applicable if the assets are transferred to a Portuguese permanent establishment of the relocated company.

Tax credit

- Taxpayers may opt to apply a tax credit for international economic double taxation regarding profits or reserves received, to which the participation exemption does not apply, and provided that the taxpayer holds, (or becomes the holder of) at least 5% of the share capital of the subsidiary.
- When chosing the abovementioned option, the taxpayer shall add to the taxable income the amount of the income tax related to the distributed profits or reserves that has been effectively paid abroad by the subsidiary.
- Regarding the tax credit for juridical international double taxation, the computation of the amount of the tax credit shall be determined per jurisdiction, considering the total amount of the respective income, except in the case of income obtained by permanent establishments, whose deduction must be assessed individually.
- The tax credit for juridical international double taxation can be carry forward for 5 tax years.

Payments on account and special payment on account

- If the previous year's tax basis for the determination of the payments on account is lower than €200, the taxpayer will not have the obligation to make payments on account.
- The PEC will now be deductible for the purposes of the computation of the payments on account.
- The special payment on account (PEC) shall now be deductible for a 12 year period (currently, four years), after which the reimbursement of the amount that remains non-deducted will no longer depend on a tax audit upon request of the taxpayer.
- The minimum amount of PEC will now be €1,750 (currently, €1,000), paid in two installments (31 July and 15 December).
- The payments on account made by the taxpayer in the previous year will no longer be deductible, for the purposes of the computation of the PEC.
- If the taxpayer opts for the simplified tax regime for CIT purposes, PEC will not be due.
- The changes regarding PEC shall be applicable to fiscal years starting on or after 1 January 2014.

Withholding tax exemption

- Interest or any other income arising from shareholder's loans, commercial paper or debt securities, paid to direct or indirect shareholders with more than 10% participation held in the year prior to the year at which the income is made available, shall be exempt from withholding tax, whenever it qualifies as a payment on account of the final tax due.

Reporting and compliance obligations

- The requirements for the application of the Double Taxation Agreements (DTA) are simplified, since the Portuguese Tax Authorities will now accept tax residency certificates valid in the jurisdiction of the beneficiary of the income.
- The same simplification of requirements is adopted for the purpose of the participation exemption regime and the EU Interest and Royalties' Directive.
- On the other hand, taxpayers will now be required to maintain relevant tax documentation for a 12 year period (currently, 10 years).

Transfer Pricing

- The minimum threshold for the existence of special relations between two entities, for transfer pricing purposes, will now be of 20% (currently 10%).
- It is now foreseen that transfer pricing rules shall apply to the operations between a Portuguese resident entity and its foreign permanent establishments, as well as between them.
- Taxpayers will now have the possibility of requiring bilateral advance pricing agreements.

Corporations and other entities that do not carry primarily a commercial, industrial or agricultural activity

- The expenses incurred and related with the statutory object of these entities will be deductible from the taxable income (capped at the respective amount), provided there is no interest of the members of the board in the economic benefits arising from their activity.

Tax rate

- The standard CIT rate will be reduced to 23%.
- It is also stated that the CIT standard rate shall be reduced to 21% in 2015, aiming at being settled at between 17% and 19% in 2016, depending of a future evaluation of the economic and financial situation of Portugal at that time.
- The elimination of the state and municipal surcharges is foreseen to occur in 2018.

Autonomous taxation

- Expenses incurred (regardless of their tax deductibility) with passenger vehicles and motorcycles, excluding vehicles that are solely powered by electrical energy, will be subject to autonomous taxation depending on their acquisition value, as follows: (i) 15%, if the acquisition value is lower than €20,000; (ii) 27,5%, if the acquisition value is between €20,000 and €35,000; (iii) 35%, if the acquisition value is €35,000 or higher.
- All the autonomous taxation rates are aggravated by 10% if the taxpayer assesses tax losses in the same tax year.
- Autonomous taxation shall not be applicable to the expenses incurred by foreign permanent establishments of Portuguese companies directly related to the respective activity.
- Additionally, some of the foreseen autonomous taxation rates will not be applicable if the taxpayer opts for the simplified tax regime.

Income derived from the sale of temporary use of patents, industrial drawings or models, subject to registration (registrated on or after 1 January 2014)

- Considered for the purposes of the computation of the taxable profit by 50% of the respective amount, with certain limitations. They should be registered on or after 2014.

Simplified tax regime

- This simplified tax regime is available for taxpayers who have obtained in the previous fiscal year a gross income not higher than €200,000 and a total balance below €500,000, among other requirements. The taxable income, which cannot be lower than 60% of the annual minimum wage, is computed as follows:
  - 0,04 of the sales and services rendered for hotel, food and beverage activities;
  - 0,75 of the income derived from the professional activities mentioned in the official schedule of activities approved by order of the Minister of Finance;
  - 0,10 of the remaining income arising from services and business-related subsidies;
  - 0,95 of the income derived from the sale or temporary use of rights of intellectual or industrial property or of know-how, other investment income, income from real estate, positive balance between capital gains and capital losses, and remainder income;
  - 1,00 of the acquisiton value in case of free of charge increases in wealth.
- Taxpayers subject to this regime will not be liable to autonomous taxation regarding representation expenses, daily allowances and compensation for travelling in the private car of the worker in the service of the employer, profits distributed by exempt entities, and expenses with bonuses or charges for any indemnity or compensation attributed to members of corporate bodies.
- Taxpayers subject to this regime will not be liable to make the special payment on account (PEC).

Limitation to the tax deductibility of financial expenses

- The threshold for the limitation of the net financial costs is reduced from €3,000,000 to €1,000,000, despite the maintenance of the alternative criteria for the deduction of 30% the profit obtained before depreciations, net financing expenses and taxes (as well as the transitional period until 2017).
- The carry-forward of the financial costs not deducted in previous years is now subordinated to the deductibility of each tax year's financial costs deductibility assessment.
- Use of FIFO criterion regarding the identification of the non-deductible net financial costs and the not-used limit that could increase the amount deductible in that period.
- In case of group taxation, the dominant company may opt to apply the limitation on the basis of the group's net financial expenses. In this case, such limitation is computed based on the result before depreciation, amortisation, net financial expenses and consolidated taxes in respect of the total number of companies included in the group.
- This option should be maintained for a minimum 3 year period, and must be reported to the tax authorities up to the end of the third month of the tax period in which it is intended to apply the option.
- If there is a change of at least 50% in the ownership of the share capital or of the voting rights of the taxpayer, it is no longer possible to carry forward net financial expenses or to deduct the unused carry forward net financial expenses.
- The concept of earnings before depreciations, net financing expenses and taxes is now foreseen in the law.

Special taxation regime for groups of companies

- The minimum percentage for the consideration as a relevant ownership is reduced from 90% to 75%.
- It is now clear in the law that an indirect ownership, through a EU resident company or a EEA resident company (bounded by administrative cooperation on tax matters), is eligible for this regime.
- From 2014 onwards, the absence of communication of changes in the composition of the Group does not imply the automatic cessation of the regime.
- In case of a change of the dominant company, there is a possibility of maintaining the regime provided a communication is sent to the tax authorities filed within 30 days upon the change.
- In the same case, the maintenance of the right to deduct carry forward tax losses generated in tax years prior to the change is possible with the permission of the tax authorities.
- Specific rules are now foreseen in case of acquisition of the dominant company of a different tax group.

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