European Holding Companies: Portugal

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A. Introduction. The SGPS tax regime

Unlike the large majority of the *participation exemption* regimes all throughout the European Union, the Portuguese one is closely linked with the specific legal status and purpose of the entities eligible to benefit from it. Indeed, only pure holding companies ("Sociedade Gestora de Participações Sociais" or SGPS), abiding by the specific legal regime stated in Decree-Law 495/88 of 30 December 1988 will have access to the tax benefits stated in article 32 of the Tax Incentives Statute ("EBF") for dividends and capital gain derived from shares.

Under the aforesaid Decree-Law, an SGPS is a company [of any type, namely a *"sociedade anónima"* (corporation), or a *"sociedade por quotas"* (limited liability company)] or which has as its sole purpose the management of shareholdings in other companies, *"as an indirect form of exercise of an economic activity"*. To that end, only the acquisition and management of non-occasional shareholdings (held for more than one year) representing more than 10% of the share capital with voting rights of the participated company are, in principle, allowed. Nevertheless a set of exceptions to this restriction facilitates the ownership of smaller shareholdings, which will not be thus unlawful whenever:

i. Their combined cost of acquisition does not exceed 30% of the overall investments of the company;

ii. Their individual cost of acquisition is not less than five million euro;

iii. They are acquired within a merger or division.

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Despite their "pure holding nature" SGPSs may render technical services to their participated companies as a secondary activity and are also allowed to own immovable property either for their own use or to be rented out to the former.

Finally, it is also important to note that, in general terms, SGPSs are not allowed to carry on financing activities, except where the lender is a participated company and the loans assume a specific legal format [eg. shareholders loans ("contrato de suprimento") or bonds].

It should also be noted that they are subject to the supervision of the General Finance Inspectorate (*"Inspecção Geral de Finanças"*) which oversees the observance of Decree-Law 495/88 of 30 December 1988. In more extreme cases such as having a *de facto* object which does not correspond to the legally mandatory object, an SGPS may be ordered to be wound up by the State Attorney.

B. Liability to Corporate Income Tax. The Corporate Income Tax rates

The *participation exemption* regime laid down for the SGPSs in the EBF is not, at least formally, a special Portuguese Corporate Tax[3] ("IRC") regime but rather a special tax incentive for these companies. Thus, SGPSs are, in general, subject to IRC at the normal rates, computed in the same way as for any other companies.

The normal CIT rate is 25%. However, a Municipal Surcharge (*Derrama*) may be charged by the Portuguese municipalities where the employees of the SGPS are located and in the proportion of the costs borne with those workers, up to a percentage of 1,5 on the taxable profits (so companies with enough carried forward losses to pay no IRC may still pay Derrama).
In addition, as part of the austerity packages that are being approved every year since the onset of the sovereign debt crisis in Europe, a new surcharge (Derrama Estadual) now levies the excess of profits over 1.5 M€ (3%) and 7.5 M€ (5%).

Although these new rates may not affect the bulk of the SGPS' tax results, which tend be composed essentially of exempt dividends and capital gains in the terms described hereunder, they are still important given that the SGPS may receive profits from services rendered, interest from loans granted to related companies or even dividends from small shareholdings

3 From here onwards, IRC will be referred to as "Corporate Income Tax" or "CIT".

(representing less than 10% of the share capital of the distributor) and be taxed, in certain cases, at a 30% rate.

C. Dividend taxation

a. EU, EEA and internal dividends received

Up until 2011, SGPSs enjoyed a very favourable tax regime for dividends received either from other Portuguese entities or from entities in the UE. Such dividends were excluded from CIT regardless of the relevant holding percentage and holding period. Hence the regime could include very small shareholdings in percentage as long as they could be considered, from an accounting perspective, as not being held as inventory or for trading purposes.

With the State Budget for 2011, taxation of dividends received by the SGPS is no longer more favourable than for other companies. Dividends are excluded from IRC in the terms of article 51 of the IRC Code, whenever the beneficiary:

- Holds no less than 10% of the distributors' share capital;
- Has owned the shares consecutively for more than one year or commits to hold them for at least one year;
- Does not benefit from a *subjective* CIT exemption;

As to the territorial scope of this CIT exclusion, dividends have to be sourced on a Portuguese, EU or EEA[4] company fulfilling the requirements laid down in Council Directive 434/90/EC of July 23 ("Parent/Subsidiary Directive" or "PSD"). Dividends attributable to a Portuguese permanent establishment of a PSD-qualifying company or of an EEA company may also benefit from the aforementioned exclusion, as long as the distributor is also a qualifying EU or EEA company.

The relevant legal provisions prescribe that exclusion from tax is also dependent on the *effective taxation* of the profits from where the concerned dividends derive. The meaning and extension of the concept of *effective taxation* has raised many doubts and criticism among scholars and specialists for its vagueness and ambiguity, prompting the Tax Administration to issue an Instruction (Circular 24/2011, of 11 November)

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4 In this case, the country concerned must be bound by mutual assistance agreements similar to those in force in the EU.

aimed at shedding some light into the most controversial points of said concept.

According to that Instruction, *effective taxation* of the income underlying the dividends paid to a Portuguese parent will have occurred whenever, on any layer of the subsidiary chain, such income has been subject to income tax. There is no express threshold on the *effective taxation* amount. It is noteworthy that the *effective taxation* requisite is deemed to be fulfilled whenever the distributor is a resident in the EU under the PSD.

Where a Portuguese resident SGPS owns less than 10% of the share capital of a resident or non-resident dividend distributor, it will not benefit from any reduction on the underlying tax paid by the distributor, thus being subject to a potentially total economic double taxation[5].

b. Dividends originated in third countries

Portuguese law does not extend the above PSD benefits to third country residents. However, resident companies investing in third countries may rely on the economic double taxation elimination mechanisms present in certain DTCs and also in some internal tax incentives provisions.

In this last group, a notable exemption from CIT on dividends is available for Portuguese companies (SGPS or others) investing in companies domiciled in the Portuguese-speaking African countries (Angola, Mozambique, Cabo Verde, São Tomé e Principe and Guinea-Bissau) and also in the Timor-Leste Democratic Republic. Dividends thus received will benefit from the CIT exclusion regime as foreseen for domestic and intra-EU distributions, although with a different threshold for the qualifying participations (25%) and a *subject to tax* clause, whereby companies taxed on profits at a rate of less than 10% or which profits derive from *passive* sources are excluded from the benefit.

In addition, some of Portugal's most important DTCs with third countries provide for the elimination of double tax on most of the underlying income in dividend distributions to Portuguese resident companies (typically 95% of the CIT imposed in the source country). Two notable cases include the DTCs with the USA and Brasil.

5 Without prejudice of the tax credit available on any withholding tax on interest payments made in the source country.

D. Foreign tax credits

Portugal operates a *per country* ordinary credit system of unilateral elimination of double taxation whereby the tax credit will correspond to the lower value of the income tax paid abroad on the creditable income or the fraction of the CIT, computed before the credit deduction, corresponding to the income taxable in the source country, but net of any expenses and costs borne (in Portugal) in relation to such income.

Pooling of income is, thus, possible as there is no *credit basket* system in place. However, given the Portuguese CIT standard rate of 25% and the current wide net of DTCs in place it is not likely that pooling of income will allow credit deductions that would not be possible had there been a *credit basket* system in place.

E. Capital gains on the sale of shareholdings by Portuguese holding companies (SGPS)

Under the *participation exemption* regime, capital gains on the sale of any shareholdings consecutively held for more than one year by SGPSs are excluded from CIT. Conversely, losses recorded in regard to the same shareholdings are not tax-deductible.

This apparently liberal regime (namely as regards the absence of a requirement on the size of the eligible shareholdings) contains some relevant exceptions, specially tailored to prevent abuse. In effect, it does not apply to shares:

(i) Acquired from related entities, from entities resident in Blacklisted Jurisdictions (jurisdictions with favourable tax regimes, as listed in a Ministerial Order) or entities resident in Portugal but subject to a special tax regime; or

(ii) Issued by a company which has resulted from a transformation (including a change in the social purpose) prior to which it was not subject to this preferential tax regime (in which case the 3 (three) year period is counted from the transformation).

F. Capital gains on the disposal of shares in Portuguese companies (eg. an SGPS)

Pursuant to Portuguese domestic law, capital gains derived by non-resident entities from the disposal of shares in Portuguese companies are exempt from Portuguese taxation unless:

(i) the non-resident entity is held, directly or indirectly, in 25% or more, by Portuguese tax resident entities; or

(ii) the non-resident entity is resident for tax purposes in a Blacklisted Jurisdiction; or,

(iii) more than 50% of the assets of the Portuguese company are directly or indirectly represented by real estate or rights *in rem* in immovable property within the Portuguese territory, or the companies disposed of are *de jure* or *de facto* holding companies that exercise control over other companies, also Portuguese tax resident, the assets of which are directly or indirectly represented, in more than 50%, by real estate or rights *in rem* in immovable property within the Portuguese territory.

Even in those circumstances where any of the exceptions above apply and therefore Portuguese domestic law does not provide for an exemption of the capital gain, DTCs entered into by Portugal usually allocate the taxing rights over capital gains on the disposal of shares to the residence State of the alienator on an exclusive basis.

G. Taxation on formation of companies and raising of equity

Portugal does not levy any tax or duty on the formation of companies or on the raising of equity (only minor registration and publication fees are due).

H. Taxation of debt financing

As far as debt financing of Portuguese holding companies is concerned, several tax issues should be considered.

First, Stamp Tax is due on (i) the use of credit and on (ii) security or guarantee provided (in the latter case, except if such security or guarantee is both simultaneous and intrinsically accessory to other taxable events, such as the use of credit). The rates vary from 0.04% for each month or fraction thereof (loan or security/guarantee with a term of less than one year, or loans where the term cannot be determined), 0.5% (loan or security/guarantee with a term of one year or more, up to and excluding five years) to 0.6% (loan or security/guarantee with a term of five years or more, as well as security or guarantee without term). Interest charged by financial institutions is also subject to a 4% Stamp Tax, which also applies to fees or commissions for bank guarantees (3%) and other financial services (4%). Some exemptions apply to shareholder loans under certain circumstances.

Second, if the Portuguese holding company adopts the SGPS status, financial costs incurred in the acquisition of shares held for at least 1 (one) year are disregarded for purposes of computing the taxable base for CIT purposes (from which, as mentioned in F above, capital gains arising from the disposal of those same shares should be excluded). Said 1 (one) year period is extended to 3 (three) years if

(i) the shares have been acquired from related entities, from entities resident in Blacklisted Jurisdictions or entities resident in Portugal but subject to a special tax regime; or

(ii) the company has resulted from a transformation prior to which it was not subject to this preferential tax regime (in which case the 3 (three) year period is counted from the transformation).

Even if financial costs are not entirely disallowed in accordance with the preceding paragraph, the deduction is still subject to the tests of the limitation on net financing expenses rules and transfer pricing rules.

With effect from 1 January 2013, Portuguese thin-capitalisation rules were repealed and replaced with a provision restricting the deductibility of net financing expenses incurred by taxpayers subject to IRC, except for finance and insurance companies. Specifically, the deductibility is denied in respect of the portion of the net financing expenses that exceed the higher of the following caps: i) € 3,000,000 and ii) 30% of EBITDA (this percentage will be introduced gradually, being reduced by 10 percentage points each year, from 70% in 2013 to 30% from 2017 onwards). The non-deductible portion of the net financing expenses in any given fiscal year may be deducted in the subsequent five fiscal years (subject in each year to those same caps). On the other hand, "unused" portion corresponding to the difference between the net financing expenses effectively deducted and the amount corresponding to 30% of the EBITDA (i.e., the amount that the taxpayer might have deducted) may also be used in the following five fiscal years. These rules apply on an individual basis even if a group of companies applies the tax consolidation regime.

Portuguese transfer pricing rules generally follow the OECD transfer pricing guidelines based on the arm's length principle, with a particular focus on stringent documentation obligations and a very wide concept of relevant relationship. The latter is broadly defined as the situation where an entity has the power to exercise, directly or indirectly, a significant influence in the management of the other, which includes the relationship between:

(i) An entity and the owners of at least 10% of its share capital or voting rights (or their spouses, ascendants and descendants);

(ii) Entities owned for at least 10% of their share capital or voting rights by the same persons (or their spouses, ascendants and descendants);

(iii) An entity and the members of its own corporate bodies (or their spouses, ascendants and descendants);

(iv) Entities with common members within their bodies (or members somehow related);

(v) Entities which pursuant to a commercial, financial, professional or legal relationship have some form of dependency (e.g. a substantial part of the activity depends on the other or the other is able to condition its management decisions);

(vi) A resident entity, or a non-resident entity with a permanent establishment in Portugal, and any entity located in a Blacklisted Jurisdiction (irrespective of any underlying relationship).

Withholding tax is charged on interest at a 25% rate when the income becomes due and payable. For non-resident beneficiaries of such interest income, the withholding represents the final tax liability. For resident companies, this withholding represents an advance payment on account of the final CIT liability. In case the recipient of the interest is resident in a country with which a DTC is in force, the above rate may be reduced. For this purpose, the relevant tax residence must be certified through appropriate forms.

Portugal implemented the Council Directive no. 2003/49/EC, of 3 June 2003, (the so-called "Interest and Royalties Directive"), according to which interest payments arising in a EU Member State shall be exempt from withholding tax in that State provided that the beneficial owner of the payment is a qualifying associated company or a EU permanent establishment of an associated company resident in another Member State (an associated company being one with which there is a direct shareholding relationship of at least 25% or with which there is a common EU shareholder of at least 25% of both associated companies, for a period of at least 2 years). Under the transitional regime, Portugal has been authorized to continue withholding tax until 30 June 2013, at a reduced 5% withholding rate (accordingly, if for example a Portuguese holding company is financed by its EU parent company, interest due on such loan will only be free from withholding tax from 1 July 2013 onwards.). For the purpose of applying the beneficial regime, a specific tax residence form attesting the fulfilment of the conditions set for in the Directive must be presented to the Portuguese payer.

If the recipient of the interest is resident in a Blacklisted Jurisdiction, or if the interest is paid to accounts in the name of one or more accountholders on behalf of undisclosed third parties and the beneficial owner is not identifiable, the withholding tax rate is increased to 30%.
Some exemptions from withholding tax may apply to interest payable on certain debt securities and on certain loans associated with the provision of public services and/or infrastructure investments.

I. DTC network

After a long period of stagnation, Portugal has been recently very active in the negotiation of DTCs. Of almost 70 DTCs signed, close to 60 are currently into force and negotiations are underway with more than a handful of other countries. Portugal's negotiation position is traditional, often clinching to the provisions of older OECD models with a view to protect its interests as source country (e.g., preserving withholding rights on royalties and conservative approaches on a wide range of subjects).

J. General anti-avoidance provision

Portuguese general tax law contains a general anti-avoidance rule under which events, deeds and contractual arrangements are deemed ineffective for tax purposes whenever carried out through fraudulent or artificial means and with abuse of legal forms, with the sole or primary aim of reducing, eliminating or deferring taxes that would otherwise be due or of obtaining tax advantages that would not otherwise, totally or partially, be achieved.

Although the rule has been in force for over a dozen years it has only been applied by the tax authorities on a handful of publicly disclosed cases and only in the last couple of years did courts started issuing judgments on the matter.

Tax planning schemes with certain features or involving particular types of dealings or transactions are required to be communicated to the tax authorities under certain circumstances. Although the use of holding companies in general is not *per se* deemed to be a planning scheme subject to disclosure, the tax authorities have listed certain structures involving holding companies as potentially inadmissible tax planning schemes (e.g., certain debt-push-down structures involving special purpose vehicles).

K. Controlled Foreign Companies

Profits arising to entities located in Blacklisted Jurisdictions or subject to an income tax which does not exceed 60% of the tax that would be paid if the beneficiary of such income were tax resident in Portugal, may be proportionally imputed – irrespective of any distribution – and immediately taxed in the hands of the Portuguese holding company:

(i) owning, directly or indirectly (included through related entities) at least 25% of the shares, voting rights or rights to income or assets of that subsidiary; or

(ii) owning, directly or indirectly (included through related entities) at least 10% of the shares, voting rights or rights to income or assets of that subsidiary, when at least 50% of the share capital or voting rights of the foreign company is held by companies or individuals resident in Portugal.

The above rule does not apply when the controlled foreign company meets cumulatively the following conditions:

(i) At least 75% of the profits arise from an agricultural or industrial activity in the territory where it is located or from the carrying on of a business activity that does not have Portuguese residents as counterparties, or, having them, is directed predominantly to the market of the territory where it is located;

(ii) The main activity of the company does not include: internal banking business, even if not carried on by credit institutions; transactions relating to insurance business, where the income results primarily from insurance of property located outside the territory of residence of the company or insurance for persons not residing in that territory; transactions in shares or securities, intellectual or industrial property rights, the provision of information relating to experience obtained in the industrial, commercial or scientific sectors or the provision of technical assistance; leasing of property other than immovable property situated in the territory of residence of the company.

L. Value Added Tax ("VAT")

VAT is a general tax on consumption, levied at each stage of the economic supply chain, including the sale to the final consumer. However, since businesses are generally able to deduct the VAT incurred, the VAT payable corresponds in principle only to the value-added at each stage. This may not be the case for holding companies as regards input VAT on services and goods purchased with a view to acquire, manage or dispose of shares. The VAT being an harmonised tax, the case-law of the Court of Justice on the matter (e.g., on cases such as 29 October 2009, Case C-29/08, *Skatteverket v AB SKF* or 27 September 2001, Case C-16/00, *Cibo Participations SA v Directeur régional des impôts du Nord-Pas-de-Calais*) is essential to shed light on the ability of holding companies deducting VAT incurred in the context of their holding activities.