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Budget Bill Revises Capital Gains Tax Regime

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Portugal's 2002 budget is subject to amendment before Parliament casts its final vote. However, it is clear that the budget bill, which was approved in a first vote on 9 November, represents an important shift in policy regarding the tax reform package approved last year, particularly as it relates to capital gains taxation.

Last year's tax reform package was structured to increase efficiency and equity. Its main purpose was to combat tax avoidance and evasion by promoting fairer tax law. The government had asserted that Portugal's tax system was biased toward goods and services, which accounted for 14.3 percent of gross domestic product (that is, 41.4 percent of total tax receipts, including social security) in 1999. Income taxes accounted for only 10 percent of GDP (that is, 29 percent of tax receipts) during the same period. In its bid to change the fiscal status quo, the government abolished several tax incentives — namely, exemptions from capital gains for individuals, and the indefinite rollover relief granted to holding companies. (For related coverage, see *Tax Notes Int'l*, 26 Mar. 2001, p. 1487, *2001 WTD 59-7*, or *Doc 2001-8701 (5 original pages)*.)

However, two main factors have changed the government's view of that strategy. The first is the ineffectiveness of the reform measures on corporate tax collections during 2001. In fact, the government collected PTE 892.6 billion in 2000 and was expecting to collect PTE 928.1 billion in 2001, according to figures presented in the 2001 budget. However, according to the latest estimates, corporate tax revenue in 2001 will not exceed PTE 859.7 billion, a decrease of PTE 32.9 billion from the 2000 revenue figure.

The second factor in the government's reassessment is the tragic events of 11 September, which have forced the government to adopt more investment-friendly measures to offset the economic slowdown occurring all over Europe.

Main Tax Changes

Capital Gains on Securities

As far as individual taxation is concerned, the tax exemption granted through 31 December 2000 to individuals who held shares for a period of more than 12 months will be reintroduced. In fact, the tax regime that entered into force on 1 January 2001, which subjected capital gains obtained by individuals on the transfer of securities to a tax on a sliding scale, has been postponed until 31 December 2002.

On the other hand, regarding the disposal of securities that have been held by individuals for less than 12 months (that is, those not benefiting from the exemption), and of financial derivative instruments and warrants, only 50 percent of the net annual gain will be subject to tax at a final rate of 10 percent. In addition, if the capital gain does not exceed EUR 2,500, and if the taxpayer elects it for aggregation (meaning that it is considered for the purposes of determining the applicable tax rate), it will be exempt from individual income tax.

The revitalisation of the Lisbon Stock Exchange — as well as the need to amend a tax reform policy

that was harming Portugal's competitive position in Europe and in the world — was, indeed, among the reasons for the change of fiscal policy. In fact, statistics show that the Lisbon Stock Exchange's main index (PSI 20) decreased by about 45 percent from January until late September 2001.

The government has again amended the tax regime on capital gains obtained by corporate entities. If the 2002 budget is approved, from 1 January 2002, capital gains derived from the transfer of tangible or intangible assets (including gains realised on indemnities for the loss of tangible assets) become taxable immediately on 50 percent of their value — if the total amount derived from the transfer is reinvested within the same tax year, the preceding year, or the next two years following the transfer. (Under Portuguese tax law, an investment in shares made in the preceding year may be considered, for tax purposes, as a reinvestment of capital gains derived from a transfer of shares executed after the above-mentioned investment. Thus, the law permits "reinvestment" in the preceding year of the total amount derived from the transfer of shares.)

Capital gains derived by corporate entities from the transfer of securities receive the same treatment outlined above, if the following requirements are met:

- the total amount arising from the transfer must be reinvested in the acquisition of securities representing the share capital of Portuguese resident companies, or in bonds issued by the Portuguese state; and
- the securities transferred must have been held for at least 12 months and must represent at least 10 percent of the shareholding of the subsidiary.

Two comments on those amendments: Previously only holding companies could benefit from the special tax regime on capital gains derived from the transfer of securities. Now all corporate entities are allowed to benefit from the same regime. Further, as far as reinvestment is concerned, the new regime may be considered a violation of EU law, on the grounds of discrimination between Portuguese companies and companies located in other EU member states. Portuguese holding companies may, however, reinvest all proceeds in foreign shares without losing the 50 percent exemption.

There are specific transitional rules to define the regime applicable to capital gains obtained in 2000 and 2001. The budget law also has clarified the tax regime relating to the taxation of capital gains derived from the transfer of securities by nonresident entities without a Portuguese permanent establishment to which the gain could be attributable.

First, from 1 January 2002, the corporate tax exemption will cover not only the transfer of securities, but also capital gains derived from the transfer of warrants issued by resident companies and financial derivative instruments, both traded in stock exchanges.

On the other hand, the new provisions clarify that the above-mentioned exemption will not apply to capital gains derived from the transfer of shares of resident companies that control other resident companies whose main assets consist of real estate located in Portugal. Until now, only capital gains derived from the transfer of securities of Portuguese companies directly owning real estate did not qualify for the exemption, and that restriction has been maintained.

Finally, the new regime has also clarified the definition of "qualified participation" for the purpose of capital gains exemptions obtained by nonresident entities with the transfer of shares. Currently, to qualify for that exemption, the nonresident corporate entity cannot transfer shares corresponding to more than 2 percent and 10 percent, respectively, of the voting rights for listed companies and other companies.

From 1 January 2002, all transfers of securities to the same entity (or to other entities controlling or controlled by it) within 12 months of the first transaction will be considered, as far as the above-mentioned limits are concerned. That means that if a nonresident company transfers, in several transactions, shares representing a total of 2.5 percent of a listed Portuguese company over a period of 12 months to the same entity, the capital gains obtained with those transactions will not qualify for the corporate tax exemption.

Dividends

The 2002 budget also reinforces provisions concerning the abolition of double taxation on dividends received by Portuguese companies. From 1 January 2002, profits/ dividends received by a Portuguese parent company from its subsidiaries located in other EU member states will be exempt from corporate income tax, provided that the Portuguese company has owned at least 10 percent of the subsidiaries for a minimum of one year. Previously, economic double taxation on dividends received from EU subsidiaries could be abolished only if the Portuguese company held 25 percent of its subsidiaries for a period of two years.

It is important to stress that holding companies continue to benefit from a special tax regime that allows them to abolish double taxation on dividends received from their subsidiaries, even if the above-mentioned requirements are not met. Further, the profits/dividends distributed by Portuguese subsidiaries to parent companies in EU member states

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continue to be subject to a provisional withholding tax at a rate of 25 percent for the first two years following the acquisition of at least 25 percent holdings in the Portuguese subsidiaries. If the minimum holding is maintained after the two-year period, and provided that the requirements outlined in article 2 of the Parent-Subsidiary Directive are met, a refund can be requested.

In addition, the 2002 budget makes the tax regime in the International Business Centre of Madeira more attractive for pure holding companies. In fact, a Madeira holding company will not only benefit from an exemption on profits/dividends received from companies located outside the European Union, but also on capital gains obtained from the transfer of shares held in those companies. Until now, only dividends distributed to Madeira holding companies could benefit from a corporate income tax exemption. The new provision concerning holding companies in Madeira is of an interpretative nature, which means it will have retroactive effects on capital gains obtained before 1 January 2002 the date the budget bill is expected to enter into force.

Antiavoidance Provisions

From 1 January 2002, nonresident companies incorporated in a low-tax jurisdiction (as identified by the Ministry of Finance),[1] and that own nonrented urban property (or property that is not used for business purposes) in Portugal, will be deemed to have obtained income in Portugal related to that property, in an amount corresponding to 1/15 of the property's tax value. That value is determined by tax authorities in accordance with municipal tax guidelines. To avoid that legal presumption, the offshore company must demonstrate that the urban property is not used by an entity located in the Portuguese territory, or is empty.

The 2002 budget also changes the rates for the local tax on real estate. Currently, the rates applicable on the taxable amount of rural property and urban property are 0.8 percent and 0.7 to 1.3 percent, respectively. For urban property, the competent municipality must define annually the applicable rate, with the decision of the Municipal Assembly communicated to the Directorate General for Taxation by 31 December of the year concerned.

Those rates will be maintained. However, from 1 January 2002, real estate owned by offshore companies will always be subject to local tax at a single rate of 2 percent. Finally, the low-tax jurisdiction blacklist also is relevant as far as CFC rules are concerned.

Corporate Tax Rate Reduced

In executing the tax reforms approved last year, the government decided to reduce the general corporate tax rate from 32 percent to 30 percent as of 1 January 2002.

The government has announced that if certain economic requirements are met, the general corporate income tax rate may be further reduced to 28 percent in 2003, and to 25 percent in subsequent years.

That decision was based on the government's desire to reduce the Portuguese tax burden, measured as a percentage of GDP, to promote private investment in Portugal. Currently, the tax burden in Portugal is slightly heavier than that of Greece, Ireland, and Spain.

A reduced corporate income tax of 20 percent continues to apply to small companies taxed under the simplified method. That method is mandatory for all small companies except SAs that (1) do not elect to keep organised accounts; (2) had a turnover of less than PTE 30 million (EUR 149,639) the previous year; and (3) are not required to have certified accounts.

Conclusions

The 2002 budget is viewed as an attempt to promote investment in Portugal. The economic climate in Portugal over the past few months suggests that GDP growth will probably slow during 2001, and inflation will remain above the Euro-zone average. In that context, fiscal policy is one of the main instruments still available to national authorities to dampen pressures and bring down inflation and the current account deficit.

The government has said that because of budgetary considerations and the need to improve efficiency, last year's tax reform package was one of the most pressing items on the structural reform

[1]Portugal's low-tax jurisdiction blacklist includes the following countries and territories: Andorra, Anguilla, Antígua and Barbuda, the Netherlands Antilles, Aruba, Ascenção, the Bahamas, Bahrain, Barbados, Belize, Bermuda, Bolívia, Brunei, the Channel Islands (Alderney, Guernsey, Jersey, Great Sark, Herm, Little Sark, Brechou, Jethou, and Lihou), the Cayman Islands, the Cocos (Keeling) Islands, Cyprus, the Cook Islands, Costa Rica, Djibouti, Dominica, United Arab Emirates, the Falkland Islands, Fiji, Gambia, Grenada, Gibraltar, Guam, Guyana, Honduras, Hong Kong, Jamaica, Jordan, the Keslin Islands, Kiribati, Kuwait, Labuan, Lebanon, Liberia, Liechtenstein, Luxembourg, the Maldives, the Isle of Man, the Northern Marianas Islands, the Marshall Islands, Mauritius, Monaco, Monserrat, Nauru, Natal, Niue, Norfolk Island, Oman, the Pacific Islands, Palau, Panama, Pitcairn Islands, French Polynesia, Puerto Rico, Qatar, the Solomon Islands, American Samoa, Samoa, St. Helena, St. Lucia, St. Kitts-Nevis, San Marino, St. Pierre and Miquelon, St. Vincent and the Grenadines, the Seychelles, Swaziland, Svalbard, Tokelau, Tonga, Trinidad and Tobago, Tristão da Cunha Island, Turks and Caicos Islands, Tuvalu, Uruguay, Vanuatu, the British Virgin Islands, the U.S. Virgin Islands, and Yemen.

agenda. However, the market now clearly shows that the government needs to play a more positive role in stimulating the economy, and it has responded by dramatically revising the capital gains regime. The revisions bring the tax regime into line with the international movement toward capital gains incentives pertaining to other categories of income.

Some of the measures can be seen as an effort by the government to restore entrepreneurs' confidence in Portugal and to boost economic growth to strengthen Portugal's competitive position in Europe. Only time will tell if that strategy is successful. ◆

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