

# TAX INFORMATION

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July 2011



## PROGRAMME OF ECONOMIC AND FINANCIAL SUPPORT FOR PORTUGAL 2011-2014

### THE MEMORANDUMS ON THE CONDITIONS ON TAX POLICY

#### I. INTRODUCTION

The Memorandum of Understanding on Specific Economic Policy Conditionality, a document containing the economic policies agreed with the European Union and that many have dubbed the «Government Programme» for this and the next three years, was signed on 17 May by the Minister of State for Finance, the Governor of the Bank of Portugal and the European Commission<sup>1</sup>. In it very ambitious measures were set out, not only in terms of revenue collection and reduction of government expenditure, but also, it addressed the strengthening of competitiveness and State structural reforms in a number of economic sectors, which had already been provided for in some cases, but in others had not been contemplated.

The Memorandum on Economic and Financial Policy was also signed on the same date, 17 May. This document sets out the objectives of the agreement made with the International Monetary Fund (IMF)<sup>2, 3</sup>, which is naturally set

along the same lines as the agreement with the European Union. The document establishes a “substantial reduction” in the *Taxa Social Única* or single social security rate by the end of July 2011. It also includes the structural benchmarks considered critical by the IMF as well as the respective periods for them to be put into practice.

Before proceeding to a more detailed analysis of these measures, it must be acknowledged that the absence of a specific tax policy that has been set out and agreed and, above all, the absence of a wider understanding (between political parties) as to the purposes and objectives of Portuguese tax policy have held the Portuguese tax system hostage to lack of clarity arising from the proliferation of special rules and exceptions. This makes its predictability, interpretation and application very difficult, but also a minimum sense of justice can be read from it. From now on, the central concern should, therefore, lie in this inability to align precise, clear and transparent instructions in the Portuguese tax system.

At this point, the measures presented in the Memoranda and by the Portuguese Government and the adjustment these measures require and make possible in the tax field - for example, the measures on the structural reduction of tax benefits, including the elimination of exemptions and the «cuts» that will be made in deductions - offer us a clear

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“Best Portuguese Tax Firm of the Year”  
*International Tax Review - Tax Awards 2006, 2008*

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<sup>1</sup> See original version at [http://www.minfinancas.pt/download\\_en.asp?num\\_links=0&link=inf\\_economica/MoU\\_EN.pdf](http://www.minfinancas.pt/download_en.asp?num_links=0&link=inf_economica/MoU_EN.pdf) and translated version at [http://www.min-financas.pt/inf\\_economica/MoU\\_PT.pdf](http://www.min-financas.pt/inf_economica/MoU_PT.pdf).

<sup>2</sup> See original version at [http://www.min-financas.pt/inf\\_economica/MEFP\\_TMou.pdf](http://www.min-financas.pt/inf_economica/MEFP_TMou.pdf) and translated version at [http://www.min-financas.pt/inf\\_economica/MEFP\\_PT\\_final.pdf](http://www.min-financas.pt/inf_economica/MEFP_PT_final.pdf).

<sup>3</sup> Annexed to this Memorandum is the Technical Memorandum of Understanding which contains the definitions of the terms used in the Memorandum of Economic and Financial Policies.

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opportunity to pause to reduce and eliminate the special and exceptional schemes that have proliferated with no real economic and social justification. Doing this will promote, transparency, and principally stability in laws and in tax revenues.

Indeed, in this context the next Government already has at its disposal an endless supply of recommendations - some now also obligations - more in the context even of procedures than structural changes, in the recent report of the Working Group on Fiscal Policy (*Competitividade, Eficiência e Justiça no Sistema Fiscal, 2009*<sup>4</sup>) and which could enable a qualitative leap over the next few years - years in which it is certain that tax revenues will remain at the heart of budgetary policy. In fact, we find in the recommendations of the said 2009 report the statement that *"the working group is not proposing a new tax reform, but a restructuring of certain legislation, the revision of certain rules and the adoption of good practices that could improve the functioning of the tax system, making it more efficient, more competitive and less unfair."*

The principal measures that make up the package of international aid to Portugal will focus mainly on reducing expenditure, with only one third corresponding to the increase in revenue<sup>5</sup>. The measures will be introduced into our legal system gradually, particularly in respect of tax legislation. In the meantime, a document<sup>6</sup> has been published on the site of the Ministry of Finance in which the system is established for the measures in the Programme for Economic and Financial Support to Portugal up to the end of 2011 and appearing in the Memorandum on Specific Economic Policy

Conditionality and the Memorandum on Economic and Financial Policy (specifying, inter alia, the deadlines, the entities involved, the measures that are structural benchmarks and also the paragraph corresponding to the Memoranda in question).

Despite the fact there is a calendar for implementation of the measures approved, it could be said that they will, as a rule, intensify over the next semester, particularly with the approval of the State Budget Law for 2012, which should incorporate some of these measures, also planned for 2013 and 2014.

It remains to be seen whether a coalition government will have the unity and coherence necessary, which everyone would like to see, to implement the measures that are needed and that are described below, because if the margin of negotiation is greater, the internal consensus will also have to be wider<sup>7</sup>.

## II. TAXATION OF COMPANIES

The planned increase in the tax burden will allow for additional revenue of EUR 150 million in each year from 2012 to 2013 and will be felt right away through the elimination of reduced rates of corporate income tax known in Portugal as IRC, which, in practice, should mean not only the elimination of the reduced rate of IRC of 12.5% applicable to taxable income up to EUR 12 500, but also the elimination of all the reduced rates provided for under special taxation rules such as the rates of 10% and 15% applicable to the system of tax benefits relating to relocation to the interior. For IRC, in addition to the elimination of reduced rates, there is a reduction in the carryover period for tax losses from four year (six years from tax losses confirmed prior to 2010) to three years. This is a measure that may, in particular, make it difficult to make

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medium and long-term investments for which the so-called payback period exceeds three years<sup>8</sup>.

Provision is also made to decrease the tax deductions allowed and to repeal subjective tax exemptions, such as those relating to public interest companies and charitable organisations. On the other hand, tax benefits subject to the general limitation period of five years provided for in the Tax Benefits Statute, known as the EBF, should be eliminated as the Memorandum of Understanding refers, in particular, to the tax benefits covered by the "sunset clause" contained in the EBF.

Finally, there will also be a reassessment of tax benefits, in particular those which lapse under the said general clause. These include the benefits relating to job creation and, as well as tax benefits for the financial system and capital markets. The latter include those given to holding companies, venture capital companies and venture capital investors. In providing for a specific deadline for application under the safeguard contained in the «sunset clause» itself, the benefits given to companies operating in the Madeira Free Zone may remain outside this process, as may the benefits expressly excluded. These are the ones applicable to pension funds and similar, or in the context of the public system of capitalisation, to employer contributions to social security schemes, retirement savings funds and plans, investment funds,

<sup>4</sup> See [http://www.min-financas.pt/inf\\_fiscal/GPFRelatorioGlobal\\_VFfinal.pdf](http://www.min-financas.pt/inf_fiscal/GPFRelatorioGlobal_VFfinal.pdf).

<sup>5</sup> See FRANCO, Francesco - "Economia e Política", in Memorandum of Economic and Financial Policies - 11 Perspectives, Nova - School of Business & Economics, May 2011, page 4.

<sup>6</sup> See [http://www.min-financas.pt/inf\\_geral/SI\\_Medidas\\_PT.pdf](http://www.min-financas.pt/inf_geral/SI_Medidas_PT.pdf).

<sup>7</sup> See TAVARES, José - "Economia e Política" in Memorandum of Economic and Financial Policies - 11 Perspectives", Nova - School of Business & Economics, May 2011, page 19.

<sup>8</sup> On the application of the law in time in a parallel situation arising from the State Budget Law for 2011 (Law 55-A/2010, of 31 December, article 99), see Legislative Order 735/2010-XVIII, of 12 August of the Secretary of State for Tax Affairs.

venture capital funds and real estate investment funds in forestry resources, as well as the exemptions applicable to real estate.

Also in respect of IRC, regional finance law should be amended so as to allow an increase in the rates applicable in the Autonomous Regions, with the upper limit of a reduction of 20% in relation to the rates applicable on the mainland. The result of this would be that the IRC rate currently applicable in the Azores of 17.5% should be increased to at least 20%, which is already the corporate income tax rate applicable in the Autonomous Region of Madeira.

Finally, also noteworthy is the proposed change to the taxation of vehicles in respect of IRC, with provision being made for a further increase in independent tax rates on companies' spending on passenger or mixed use vehicles.

We would stress, however, that provision is made for incentives to increase the competitiveness of Portuguese companies by lowering their social security charges and lowering the single social security rate for which

employers are responsible, as long as this reduction is compensated by the increase in excise duties, as expressly provided for in the Memorandum on Economic and Financial Policy.

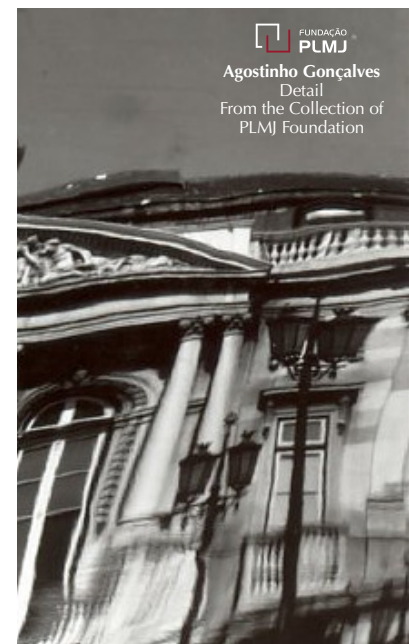
### III. TAXATION OF INDIVIDUALS

Although no provision is made for a general increase in rates of personal income tax known as IRS, what we have already said in relation to the increase in the tax rates for the Autonomous Regions also applies here.

The main measures that will affect households which are aimed at making it possible to collect revenue of EUR 150 million in 2012 and EUR 175 million in should be reflected in a reduction in itemised deductions, immediately through a reduction in the respective categories and the establishment of upper limits on the basis of the tax bands. It is intended that there will be reductions in the higher bands and elimination of the highest band. In practice, this corresponds to a widening of the scope of application of a measure that already exists, although only in relation to some itemised deductions. A maximum limit will

also be introduced for deductions for healthcare expenses that we assume will be in respect of expenses that are exempt from VAT or subject to the reduced rate of 6% of VAT which currently has no deduction limit.

Provision is also made for the continuing and progressive convergence of the tax system for pensions and income from work. This could be achieved by altering the rules for specific deduction of category H income (pensions) from IRS. Also in respect of income from work, it is intended that there will be a revision of taxation of benefits in kind. The result of this will probably be an increase this taxation or a widening of its scope. Finally, it should be emphasised that, despite apparently intending that social benefits such as unemployment subsidies, family allowance and maternity pay, among others, would be subject to IRS, it had already been made clear by the (previous) government, that these should only be included for the purposes of determining the rate applicable to the whole of the income, as happens with other exempt income. Bringing both measures into effect will allow the State to collect EUR 159 million in each year of 2012 and 2013.



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In respect of housing, the objective is to stimulate the rental market. Accordingly, itemised deductions should be eliminated in respect of home mortgage loan payments right away in 2012, even for mortgages that are already in force. It is also intended that there should be a gradual elimination of the tax deductions for interest paid under these mortgages. In the case of new mortgages, households will not be allowed to make a tax deduction in respect of either capital or mortgage payments. The tax deduction on rent paid by tenants will also be gradually eliminated. The aim of this is to both reduce the excessive indebtedness of Portuguese families and at the same time, to boost the rental market and, in the final analysis, the mobility of the workforce itself, which is very low in Portugal.

With the impact of the new cost burdens for housing, it is also intended that the tax value of property will be re-evaluated so as to allow for an increase in revenue of at least EUR 150 million. This step is also intended to bring the tax value closer to the market value. Above all, an increase in the *Imposto Municipal sobre Imóveis (IMI)* - the local government property tax - is also planned. The consequence of this will be a double increase in the tax burden in this sector because IMI is charged on the tax value of the property. The increase in IMI, which will impose a greater penalty on empty properties, is also intended to promote the rental market, since tenants should be able to continue to deduct the IMI paid annually in respect of such rentals for the purposes of IRS. In the same way, the temporary exemption from IMI that applies to property bought to be used as a person's own residence should be reviewed so as to reduce the current periods of four and eight years in accordance with the value of the property, a measure that should result in additional revenue of EUR 250 million in 2012.

Finally, a reduction in the municipal tax on transfers of property for value, known as IMT, is also planned. This will certainly increase transfers of

properties and discourage the fraud that arises from the undervaluation of properties. These objectives could, however, be boosted in an even more appropriate way through the re-evaluation of IMT tax exemptions for the acquisition of properties intended to be used as residences that, today, have no reasonable justification based on the ration of houses per household (because of the existence of an absolutely excessive ratio of around 4 500 000/5 000 000 of households to around 6 000 000/6 500 000 residential properties), which will probably allow a reduction in the rate of IMT to much lower levels and its transformation into nothing more than a payment for registration.

#### IV. CONSUMER TAXATION

Provision is made for the indexation of increases in excise duties to the rate of inflation and for the measures be adopted in 2012 and extended in 2013 and 2014. This will lead to additional revenue of EUR 250 million in 2012 and EUR 150 million in 2013.

Provision is also made for an increase in the tax burden on the sale of motor vehicles in 2012 through an increase in motor vehicle tax (ISV), as well as the elimination of the exemptions applicable to road tax (IUC). Furthermore, the excise duties on tobacco will be increased and new excise duties will be imposed on electricity in accordance with EU Directive 2003/96, which has already been transposed in a number of countries.

To allow for an increase in revenue from VAT of EUR 410 million annually, the Memorandum of Understanding makes provision for some categories of products and services currently included in Lists I and II of the table annexed to the VAT Code to which reduced and intermediary rates are respectively applicable to be altered. Some products and services currently included in List I - such as electricity and gas - will become subject to a higher rate, that is, the intermediate

rate or the normal rate. Some products and services currently included in List II will become subject to the normal rate. For this purpose, these products will suffer an increase in the rate of VAT that is currently applicable to them.

Apart from the specific cases of electricity and gas - measures that will affect private individuals in particular - the Memorandum of Understanding does not make any provision in respect of the goods and services for which taxation will be increased. It should be remembered that currently, List I includes food products, agricultural production items, provision of forestry services, newspapers, magazines, pharmaceutical products and contracting services, among others and that, in turn, List II provides for the application of an intermediate rate to food products for humans, provision of food and beverage services and also other goods such as oil, petrol and agricultural tools.

The reduction in the various exemptions provided for in the VAT Code should also be noted. The number of exemptions provided for in the VAT Code is vast and includes, among other, real estate operations, financial operations, medical services, the provision of teaching services or services provided by not-for-profit organisations. In respect of exemptions, provision is also made for a VAT exemption for the universal postal service and this measure should be put into effect from September 2011. It should be noted that this issues had already been discussed by the competition authority and the European Parliament.

As regards the rest, we cannot anticipate what exemptions will be eliminated. This means it will be necessary to wait to find out whether the reduction in these tax benefits will also come to burden real estate operations or, instead, whether other exemptions such as, for example, the transfer of copyright or the provision of services by promoters of actors and sportsmen and women will come into play.

In tax proceedings, provision has been made for «special» interest to be charged with rates higher than market rates, instead of providing a guarantee, when the legality of the payment in question is being challenged in court. Interest will be charged on the value of debt that is subject to tax litigation and this translates into an incentive for taxpayers to pay.

Finally, the changes to the law on regional finances referred to above will also result in an increase in the VAT rates applicable in the Autonomous Regions of Madeira and the Azores.

## V. THE TAX AUTHORITIES AND TAX PROCEDURE

The memorandum also provides for the merger for of three directorates-general: taxes - *Direcção-Geral dos Impostos (DGCI)*, customs and excise - *Direcção-Geral das Alfandegas e Impostos Especiais sobre o Consumo (DGAIEC)* and IT and tax and customs services support - *Direcção-Geral de Informática e Apoio aos Serviços Tributários e Aduaneiros (DGITA)*. There will also be an analysis of the cost and benefits of including the functions of collection of social security within this merger. Both these measures will be the subject of a study to be carried out in September 2011.

The human resources allocated to inspection by the tax authorities will be increased and will now account for at least 30% of total employees. This will come about, fundamentally, through the re-allocation of other sectors of public and tax administration. The tax authorities' inspection powers will also be strengthened as will the interpretive rules that are issued in order to ensure greater uniformity in the interpretation and application of tax rules. An evaluation report on the current state of information and control systems existing in tax administration will also be prepared in terms of which new proposals for reform must be submitted on the basis of this report.

Finally, but of extreme importance and representing an increased annual revenue of at least EUR 175 million, the tax authorities must prepare a strategic plan by the end of October 2011. This plan is to be implemented between 2012 and 2014 and will focus primarily on combating tax evasion, fraud and informality, and boosting tax inspection and increased revenues by means of risk management mechanisms.

## VI. TAX COURTS AND TAX PROCEEDINGS

Specialised sections will be created in the tax courts to review more complex tax issues and for cases of higher value, and provision is made for judges to be assisted by specialised technical teams. In particular, a special group of judges is to be created as early as the second semester of 2011 and assigned to the resolution of disputes of a value of more than one million euros that are pending before tax courts, with a view to them being brought to a conclusion in late 2012. This is to be put into effect in July 2011 in the document that summarises the measures of the Programme for Economic and Financial Support to Portugal to be implement by the end of 2011.

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In addition to this, where there is failure to comply with a judgment, provision is made for the application of special legal interest, a measure we believe will hit the tax authorities, as, in the event of failure to comply with a judicial decision, taxpayers have always provided security for the suspension of the enforcement proceedings. As this measure, which is not clear, is included in the chapter dedicated to increasing the speed of dispute resolution, we believe that such special interest should be subject to a rate higher than the one normally applicable in order to compel the tax authorities to comply with judicial decisions, thus avoiding additional costs. However, it is also questionable whether subjecting this special interest to a lower rate would ultimately relieve the State of the costs of the failure to comply with judicial decisions that are unfavourable to it.

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Lisbon, 5 July 2011  
21/ 2011