TAX INFORMATION

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WITHHOLDING TAX EXEMPTION ON THE PAYMENT OF INTEREST AND ROYALTIES

INTEREST AND ROYALTIES DIRECTIVE

On 6 June 2013 the Council of Ministers approved the bill to finalise the transposition of Directive 2003/49/EC of the Council of 3 June into the IRC (corporate income tax) Code. The Directive, which establishes a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, is commonly known as the 'Interest & Royalties Directive'.

Introduction

On 6 June 2013 the Council of Ministers approved the bill to finalise the transposition of Directive 2003/49/EC of the Council of 3 June into the IRC (corporate income tax) Code. The Directive, which establishes a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, is commonly known as the 'Interest & Royalties Directive'.

The Directive establishes a system for exemption from tax in the source State in relation to payments of interest and royalties made between companies that qualify as "associated companies" (see the definition below).

Despite the fact the Directive dates from 2003, Portugal benefited from a transitional period of eight years for its full application during which the rates for withholding tax applicable to the payment of interest and royalties between associated companies were progressively reduced, first to 10%, and then, over the last four years to 5%.

From 1 July 2013, the retention of IRC (corporate income tax) at source will cease to apply as long as certain requirements are met.

In what circumstances may companies benefit from a withholding tax exemption?

Subject to any amendments to the final version of the bill that has now been approved, article 96 of the IRC Code provides that the application of the reduced withholding tax rate of 5% (and in the future "the 0% rate"), applicable to interest and royalties due or paid by companies resident in Portugal or by their permanent establishments to associated companies situated in Member States of the European Union, depends on whether the following conditions are met:

a) Companies that are the beneficial owners of interest or royalties (i) are subject to one of the taxes on income mentioned in Article 3(a)(iii) of Directive 2003/49/EC without benefitting from any exemption; (ii) take one of the legal forms mentioned in the Annex to Directive 2003/49/EC; and (iii) in accordance with the tax laws of a Member State are deemed to be resident in a Member State of the European Union and are not, within the meaning of a Double Taxation Agreement (DTA) concluded with a third State, considered to be resident for tax purposes outside the European Union;

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b) The company to which payments of interest or royalties are made is deemed to be the "beneficial owner" which will be the case if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person. For a permanent establishment to be treated as the "beneficial owner", the debt-claim, right or use of information in respect of which interest or royalty payments arise must be effectively connected with that permanent establishment for income taxation purposes;

c) Any company paying the income that is resident in Portugal (or a company of another Member State that has a permanent establishment in Portugal) is treated as an «associate company» of a second company that is the beneficial owner of interest or royalties (or whose permanent establishment is treated as beneficial owner of this same income). This is the case when (i) the beneficial owner company or the paying company has a direct minimum holding of 25 % in the capital of the other company; or (ii) when the third company has a direct minimum holding of 25 % both in the capital of the beneficial owner company and in the capital of the paying company and, in any of these cases, the holding is owned without interruption for a minimum period of two years;

d) When the payment is made by a permanent establishment, the interest or the royalties are tax-deductible expenses in relation to the activity it carries on, and are deductible for the purpose of determining the taxable income imputable to it.

What formalities are required?

Companies that are the beneficial owners of the income have the burden of proving to the entity that is under the obligation to apply the withholding tax that they meet the requirements described above. They must do this by presenting the special form for this purpose - to be approved by the Minister of State and of Finance – prior to the point at which the obligation to pay the tax to be retained to the State arises.

Whenever the period of two years for owning the minimum holding (25%) is completed after the date on which the obligation to withhold the tax arises, the interest or royalties due will be subject to withholding tax at the rate of 25% which may be reduced under the terms of any DTA that is in force between Portugal and the country of residence of the company that is the beneficial owner of the income and as long as any formalities established by law for this purpose have been met. Once the two-year holding period is completed, the beneficial owner company may apply for the repayment of the withholding tax within two years of the point at which the requirements on which the application of the Directive depends are met.

Extension of the Regime to the Swiss Confederation

Finally, it is important to note that the bill under consideration here extends the application of the withholding tax exemption to companies resident in the Swiss Confederation (as long as the requirements described above are met) under the terms and conditions laid down in article 15 of the Convention signed between the European Union and the Swiss Confederation.

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