Cross Border Business Restructuring in Portugal

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to the IFA 2011 Paris Congress, Main Subject 1 - Cross Border Business Restructuring

7th Annual Ernst & Young European Transfer Pricing Forum / 28 October 2010

Scope

- Cross-border redeployment by a multinational enterprise of functions, assets and/or risks

- Business *vs.* Company restructuring and M&A standpoint
  - Business combinations (mergers, divisions, contributions and exchanges of shares)
  - Transformation and liquidation of companies

Legal panorama

- Developed transfer pricing rules (article 63 of the IRC Code) and regulations (Ministerial Order nr. 1446-C/2001) in 2001
- Exit tax rules in 2005
- Advanced Pricing Agreements in 2008

Case law panorama

- Transfer pricing is a direct direct method of taxable income appraisal and not an indirect one:
  - It is based on the taxpayer's taxable income as shown by accounting records and not on presumptions or activity evidence
  - Tax authorities bear the burden of proof in adjustments

- Distinction between royalties and services, and cost contribution, sharing and service agreements
  - On issues like withholding tax obligations and cost acknowledgement and acceptance
  - Not on transfer pricing details

Current status

- No specific statutory regulation of business restructurings, although explicit reference to business restructuring transactions being covered by transfer pricing in the Ministerial Order

- No specific legal scholarship, tax administration doctrine and case law

- But: some Advanced Pricing Agreements, Tax Inspections and Tax Advisor experience on the subject

Transfer pricing rule

- For “commercial” and “financial” transactions
- A principle of transaction-by-transaction analysis, with exceptions
  - Business restructuring analysis, although not stated in the Ministerial Order as one, in general should be performed on an aggregated basis

“Commercial” and “financial” transactions *vs.* exit tax rule

- This seems to imply a dealing that non-related parties would engage in (e.g. sale), or one whose structure is equivalent (e.g. transfer of a finished product from a Portuguese PE factory to a foreign PE shop of the same foreign company)

- Capital operations between a shareholder and a company (e.g. subscription of share capital), in which the shareholder is acting in such a capacity (and not as a service provider or a loan creditor), and the closing of a PE *per se* (with the transfer abroad of its assets) are not, in our view, “commercial” or “financial” “*operações*”, if they are “*operações*” at all

Company *and* business restructuring (conversions)

- In Portugal, contributions of branches of activity may enable a *conversion of a PE into a subsidiary*, either under a tax neutrality and deferral regime, if certain requirements are complied with, or assessing gains and losses, if not

- Liquidation and partition of a company may, reversely, enable the *conversion of subsidiary into a PE*; in this case no tax neutrality and deferral regime is available

- Emigrating the tax residence of a Portuguese company, when all assets remain allocated to a Portuguese PE, enables the *conversion of subsidiary into a PE;* in this case a tax neutrality and deferral regime is available

- Although these issues revolve mainly around company restructuring, they also involve business restructuring, as the above conversions will inevitably shift certain functions and risks to the head office

Company *and* business restructuring (transformations)

- The tax neutrality rule on the transformation of companies from one corporate type to another also has an international scope
  - it applies whenever a foreign company transforms itself in a Portuguese company, via a transfer of its registered office into Portuguese territory (thereby “redomiciling” and acquiring a Portuguese tax residence)
  - the book value of existing assets should be kept for tax purposes, thereby implying a future taxation in Portugal of hidden reserves existing at the time of immigration, which may lead to double taxation in cases where the previous state of residence has levied an exit tax
  - the case of the transformation / redomiciliation into a Portuguese company of a Belgian company (previously with a PE in Portugal); losses existing at the Portuguese PE level may be deducted by the company upon immigration, provided that there is no substantial change in the developed activities or corporate object

Company *and* business restructuring (entrepreneur)

- Tax neutrality and deferral regime on the transfer of a going concern of an individual entrepreneur as a contribution in kind to the capital of a company
  - Applicable only to contributions to the capital of companies with both registered office and place of effective management in Portugal,
  - if the participation by the contributor reaches a minimum of 50%,
  - the activities of the individual and of the company are substantially similar,
  - the assets and liabilities are contributed under their net accounting value, and
  - the stock attributed to the individual is valued for Personal Income Tax purposes according to the net accounting value of the assets and liabilities contributed

PE taxation

- The tax authorities tend to view the profit imputable to the PE as encompassing the sale or the termination of the PE itself
- The IRC Code defines the taxable income of a PE as income of any sort obtained “through it” (together with a limited force of attraction principle)
- The sale of a PE may include both gains on its fixed assets and profits on its inventory, which are imputable to the PE itself (“deemed sale”)
- However, there may be an element of goodwill which is not allocable to those assets or inventory, and which is not obtained “through it” but “above it” by the head office itself. There is no clear basis for taxing this goodwill in the IRC Code

Exit taxation

- Whenever:

  - a company ceases to be tax resident in Portugal (head office and place of effective management are transferred outside / tax residence is lost due to the application of a tie-breaker clause in a tax treaty, but only where no place of management is left)
  - a PE winds-up its activities herein, or
  - transfers business assets outside the Portuguese territory.

- If a partial transfer of assets takes place upon emigration, only the assets allocated to a Portuguese PE remain untaxed

- Taxation on the shareholders of the emigrated company on the difference between the acquisition cost of the shares and the market value of the company's business assets at the time of the transfer, as if the company had been liquidated and partitioned

PE Exit taxation

- Whenever an individual asset is transferred or, rather, when a (partial) winding-up of business takes place?
  - The header of the provision in question refers only to cases of termination of activity
  - Transactions between a non-resident entity and its permanent establishment situated in Portuguese territory, or between this and other establishments outside of this territory, are already covered by the transfer pricing rule
  - The relevant scope of the article is to impose exit taxation in cases of partial termination of activity, towards the head office, and where no consideration is paid for the transfer of assets
  - Moving machinery within a group, namely from a Portuguese PE factory to a foreign PE factory of the same company should be considered as a "transaction" and therefore a deemed sale covered by the transfer pricing rule
  - The closing of an R & D function of a Portuguese PE would be considered as a "transfer" of relevant intangibles to the head office covered by the exit tax rule
  - Indeed, if cases other than the partial winding-up of business were included in the scope of the exit tax rule there would be an overlap with the transfer pricing rule

Conflicts between the IRC Code and article 9 of the OECD-MC (1)

- Under domestic law a 10% (direct or indirect) holding in capital or voting rights and the existence of an economic dependency situation arising from commercial, financial, factual or legal relations gives rise to “special relations”

- Under the OECD-MC a (direct or indirect) “*participation in the management, control or capital*” which gives rise to an effective power to influence the terms of a transaction must exist in order for enterprises to be deemed associated

Conflicts between the IRC Code and article 9 of the OECD-MC (2)

- Transfer pricing adjustments of transactions between two resident entities are in principle to be carried out by Tax Authorities, conversely to the positive adjustments in transactions with non-resident entities, between a non-resident entity and its Portuguese PE, and on entities with activities with more than one IRC regime, which must be made by the taxpayer itself

- These rules, in the opinion of some authors, are in breach of article 24 (5) and (5) of the OECD-MC, at least in cases covered by treaties pre-existing the 2008 changes to the Commentary on article 24

Conflicts between the IRC Code and article 9 of the OECD-MC (3)

- A domestic rule fully denies the deductibility of losses incurred in the transfer of stock by a non-pure holding company and between related entities even in cases where the arm’s length principle is fully respected

- According to one scholar, article 9 of the OECD-MC imposes a sharing of cost and profit margins between the contracting States, and Portugal cannot circumvent the loss in tax revenue deriving from an arm ’s length transaction / breach the reciprocity principle

Thank you!

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