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REPORT

From: General Secretariat of the Council
To: Permanent Representatives Committee/Council

Subject: Code of Conduct Group (Business Taxation)
– Report to the Council
= Endorsement

Portugal's notional interest deduction regime (PT018)

I/ AGREED DESCRIPTION

The following description was agreed by the Code of Conduct Group on 12 April 2018:

1. Name of the regime:

Remuneração convencional do capital social [Notional allowance for share capital]

2. Year of introduction / entry into force:

2008 (with amendments in 2014, 2017 and 2018)

3. Please attach (or provide a link to) the relevant legislation which introduced/amended your NID regime and any administrative guidance providing clarifications (if in a language other than English, please provide a translation):

The current applicable legislation on this regime is article 41-A of the Portuguese tax relief Statute (Estatuto dos Benefícios Fiscais - EBF) which refers to Article 67(1)(b) of the Corporate Income Tax (IRC) Code.

The Article 263 of the Law No. 114/2017, of 29 December 2017, which came into force on 1 January 2018, introduces some amendments in Article 41-A (1) of EBF.

These articles are available here:

http://info.portaldasfinancas.gov.pt/pt/informacao_fiscal/codigos_tributarios/bf_rep/bf41A.htm

http://info.portaldasfinancas.gov.pt/pt/informacao_fiscal/codigos_tributarios/CIRC_2R/irc67.htm

The previous NID regime (2014-2016) granted a notional deduction of 5% to SMEs for cash contributions on incorporation or for the share capital increases. The allowance - equal to the product between the capital contributions in cash and a rate of 5% - was permitted for four years and the tax benefit could not be greater than € 200.000,00 over a three years period.

This back-end NID regime is still applicable to the contributions and increases of share capital paid-up until 1 January 2017, as establish in a transitional disposition for the Portuguese tax relief statute, provided in Article 226 of the Law no. 42/2016, of 28 December.

A non-official translation of the relevant legislation is attached. In the updated translation, the wording changed that shall be applicable from 01.01.2018 is highlighted in BOLD.

4. Please describe the scope of entities that can claim a NID deduction (companies based in your country / treatment of PE of foreign companies):

Only resident companies (with head office or place of effective management in the Portuguese territory) can benefit from the regime as the base of the allowance are contributions to share capital.

Permanent establishment of non-resident companies would not be eligible for this regime.

5. NID formula:

5.1. Reference Rate: please describe the formula to determine the deductible interest rate; provide the applicable rates for the previous years (since entry into force):

Under the «Notional allowance for share capital» regime a company is granted a deduction against the corporate income tax base that is equal to the product between the amount of shareholders' new contributions for the incorporation or the increase of the company's share capital and a given notional rate.

The notional rate is fixed by the law.

Notional rates applicable since entry into force of the regime are:

- 2008 to 2013: 3%
- 2014 to 2016: 5%
- From 2017: 7%

5.2. Equity: is your regime stock-based or an incremental regime?

The Portuguese NID regime is an incremental regime. It foresees an explicit link to company' share capital new contributions.

5.3. Equity: please define the equity on which the interest can be deducted:

The notional rate of return is applicable to share capital' new contributions up to € 2 000 000 made by the shareholders or third party creditors or by retaining earnings for the purposes of the company's incorporation or increases of its share capital.

6. Limitations applicable to the amount of notional interest deduction:

6.1: Does your legislation provide for a maximum amount of taxable income against which the NID can be claimed? If so, please describe the mechanism and state the lowest effective tax rate that can be achieved by using the maximum amount of NID:

The deduction provide by this regime is determined by applying a notional rate of return to the amount of "new share capital" (contributions towards incorporation or for the increase of the share capital) used in the beneficiary company in a specific year, as a mean to reduce the indebtedness in the corporate sector and address the difference in the treatment of debt and equity.

Under this regime, the amount of the allowance for corporate share capital is deductible from the company's taxable profits in the taxation period in which the capital contributions were paid-up and within the subsequent five taxation periods.

The law does not provide any limitation about the type or de value of taxable income against which the deduction can be made.

Currently, the NID can only be claimed as a result of the application of the notional rate of 7% to a maximum amount of € 2.000.000,00 (see Article 41-A (1)).

As such, the maximum allowance admitted for each company is €140.000 per year.

6.2: Can the NID create losses? If so, please describe how those losses can be used by the taxpayers (carry-back, carry-forward, time and amount limitations):

If in a given year, the amount of the NID exceeds the company's taxable profits, the surplus can be carried forward in accordance with the general provisions of the Portuguese CIT Code (IRC), i.e. for a period of 5 years, however the deduction of losses cannot exceed 70% of the taxable profit in each tax period.

7. Please describe the treatment of distributions made out of profits relieved from tax through a NID claim:

No special treatment is provided to profits distributions during the taxable periods when the NID is applicable.

However, the company which used the NID cannot reduce its share capital by paying back the shareholders, either during the taxation period in which the capital contributions were paid-up for the purposes of standard share capital remuneration or within the subsequent five taxation periods.

Non-compliance with this condition will be penalized with the inclusion as income of the sum of amounts deducted as «Notional allowance for share capital» increased by 15%.

8. Please describe any limitations of scope in your legislation (exclusion of some specific assets, participations, treatment of foreign PE of a domestic company):

In addition to the other limitations mentioned below, the «Notional allowance for share capital» regime does not apply if the company' taxable profit is determined by indirect methods.

The regime does not consider other components if they do not correspond (directly or indirectly) to company' share capital cash contributions. So transfers of any kind of assets or treatment of participations and foreign PE are not relevant issues.

9. Do you have specific anti-abuse provisions in your legislation that may apply in the following fields (if so, please explain the measure):

9.1: Intra-group loans and loans involving associated enterprises:

To avoid "cascading" effects and abuses, the law defines a specific anti-avoidance rule [see article 41-A(6)] for intra-group transactions in order to exclude the allowance where, in the same taxation period or in one of the previous five taxation periods, it was or had been applied to companies

holding directly or indirectly an interest in the share capital of the beneficiary company, or that are directly or indirectly held by the same company.

9.2: Cash contributions and contributions in kind;

The NID applies only to cash contributions for the company's incorporation or for the increase of the company share capital.

Share capital increases through contributions in kind are only eligible in case of conversion of credits that have been previously granted by the shareholders or third parties to the beneficiary company or by retaining the profits of the current financial year [see Article 41-A (2) (a)].

The NID only applies to share capital increases from the conversion of:

- a) shareholder loans occurring after 1 January 2017 or after the first day of the taxation period beginning after such date where the taxation period shall not correspond to the calendar year [see Article 41-A (2) (c)].
- b) third parties credits conversion of third parties credits occurring after 1 January 2018 or after the first day of the taxation period beginning after such date where the taxation period shall not correspond to the calendar year [see Article 41-A (2) (d)].

9.3: Transfers of participations;

N/A

9.4: The re-categorisation of old capital as new capital through liquidations and the creation of start-ups;

N/A

9.5: The creation of subsidiaries;

N/A

9.6: Acquisitions of businesses held by associated enterprises;

N/A

9.7: Double-dipping structures combining interest deductibility and deductions under the AGI;

As establish in Article 41-A (5) of EBF and Article 67(1) (b) of IRC Code, the deduction under the «Notional allowance for share capital» regime by a company implies a reduction of the limit on the deductibility of funding expenditure, from 30% to 25% of EBITDA - Earnings Before Interest Taxes Depreciation and Amortization.

9.8: Increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date.

N/A

10. Do you have a general anti-abuse provision in your legislation?

Yes. Portuguese GAAR is established in Article 38 (2) of the Portuguese General Taxation Law.

11. Please describe the administrative procedures to benefit from the NID:

There are no specific administrative procedures to benefit from the «Notional allowance for share capital» regime. This NID regime does not depend on a ruling and Tax Authority does not provide it by ruling. The qualifying companies claim the application of the NID when they file their annual tax returns.

Follow up questions:

12. Do you have any relevant data on the actual application of the regime?

Please find bellow some data available which allow the quantification of the de facto effect of the Portuguese NID Regime on a two-year period:

TAX PERIOD	2015	2016
NUMBER OF BENEFICIARY COMPANIES	2044	3299
GLOBAL AMOUNT OF DEDUCTIONS TO THE TAXABLE PROFIT	4.903.392,39 €	7.532.554,60 €
TOTAL TAX EXPENDITURE	917.581,39 €	1.407.269,82 €

13. Is there any general provision in your NID which prevents cumulating the benefit of the NID with benefits from other preferential regimes?

As explained in answer to question 9.7., the deduction under the «Notional allowance for share capital» implies a reduction of the limit on the deductibility of financing expenses.

14. In question 8 you have stated that foreign Permanent establishments of Portuguese companies are "not relevant issues" for this regime, could you clarify if this means that the equity attributable to a foreign PE of a Portuguese company is excluded from the NID base?

Resident companies are subject to tax on worldwide profits and the domestic CIT rules do not allow for the imputation of share capital to a foreign PE of a resident company. So the regime apply to relevant share capital contributions (which are the NID base), irrespective of the Portuguese company having (or not) a foreign PE.

15. In relation to questions 9.3, 9.4, 9.5, 9.6, and 9.8 you have replied N/A as regards these anti-abuse rules. Does this mean in your view that you they are not necessary in the case of the Portuguese NID regime?

Yes. In our view, specific anti-abuse rules in the situations described in 9.3. (transfers of participations), 9.4. (re-categorization of old capital), 9.5. (creation of subsidiaries) and 9.6 (acquisitions of business held by associated enterprises) are not necessary.

Please note that the Portuguese NID regime is only applicable to capital contributions by shareholders in the moment of the company's incorporation or in the increase of the share capital (Article 41-A (2) (a)), which means that increases in equity deriving from the transfers of any participations, acquisition of business and/or the re-categorization of old capital are not eligible.

On other hand, this tax benefit is not applicable where, in the same taxation period or in one of the previous five taxation periods, it was or had been applied to companies holding directly or indirectly an interest in the share capital of the beneficiary company, or that are directly or indirectly held by the same company for the part referring to the amount of contributions paid up to the share capital of such companies which had benefitted from this scheme (Article 41-A (6)), which avoids the cascade application of this benefit, namely through the creation of subsidiaries.

In any case, the Portuguese GAAR will always be applicable.

Additional questions to Portugal

1/9.2 (add) : Are there anti-abuse rules that prevent a group from changing existing equity to incremental equity e.g., when a parent company makes a cash contribution to its subsidiary or to relocate equity by using equity from other companies in the same group?

If yes, do the rules also cover existing equity originating from abroad, when a foreign company makes a cash contribution to its subsidiary resident in Portugal?

Besides the anti-avoidance rule established in article 41-A(6) [already mentioned in 9.1.] which intends to avoid "cascading" effects of NID's benefits in intra-group schemes, there are no other specific anti-abuses in this matter.

However, we have to bear in mind that the regime does not consider other components of equity unless it correspond to a company' share capital contributions (towards initial incorporation or increase).

The company will only benefit from the NID on the increase of its own share capital and the existing capital or any other type of equity allocated to other companies in the same group is not taken into account for the computation of the NID.

2. In your reply to question 5.1, you provide with the applicable notional rates since 2008. Could you explain the economic rationale on which these rates are based?

The notional rates are fixed in the law and intend to incentive the increase of shareholders capital, as a mean to reduce the level of the indebtedness in the corporate sector and address the debt bias arising from the differences in the tax treatment of debt and capital.

In theory the notional rate should be equal to a long term risk-free interest rate accrued by a risk premium.

Please note that, in the years after 2009, the financing conditions of the Portuguese economy had deteriorated considerably duly justifying the increase in the notional rate applicable.

3. Under answer 9 you indicate certain anti-avoidance measures:

a) Could you provide examples of cases where you made use of the anti-avoidance clause; or the general anti-abuse clause and rejected transactions where the measure has been used without economic rationale just to benefit from the regime?

The anti-avoidance rule established in article 41-A(6) was only introduced by Law 42/2016, 28th December and as such is only applicable to the tax years starting from the 1st January 2017 whose tax returns will be due only in (or after) May 2018,

Please note that in the previous tax years the application of this regime was subject to the de minimis state aid rules.

b) Have you issued any guidance as to how you will implement the anti-avoidance clause for this regime in practice?

It was not issued any guidance on this regime.

4. In your answer to question 6.1 you indicate that the Portuguese NID can only be claimed by the application of the notional rate of 7% to a maximum amount of € 2.000.000,00. Could you explain the rationale for this maximum amount?

This regime is mainly aimed to reduce indebtedness of the Portuguese SME, so the cap on the NID deduction intends to limit the global amount of tax expenditure related to this scheme on the assumption that it will be used by a large number of companies (i.e. it's a "SME threshold" that limits the lowest effective tax rate that may be achieved with a maximum possible NID deduction).

5. In your answer to question 7 you indicate that the company which used the NID cannot reduce its share capital by paying back the shareholders and that failure to comply with this condition will be penalized with the inclusion as income of the sum of amounts deducted increased by 15%. Could you explain further how this rule works in practice?

This rule means that in those circumstances in which a company reduce its share capital after applying the NID to new capital contributions (in the same taxation period or within the subsequent five taxation periods) the amounts deducted to its tax base, under this regime, will be added back to the tax base of the tax year in which the company has reduced its share capital, accrued by 15%.

6. Thank you for the data you provided under additional question 1. We would be grateful if you could specify:

- **Amongst the 3299 taxpayers benefiting from the regime in 2016, the proportion of directly or indirectly foreign owned companies and of Portuguese owned companies. When providing data on foreign owned companies, could you please specify whether it is majority (over 50% owned directly or indirectly) foreign owned companies?**

From the 3299 taxpayers benefiting from the regime in 2016, only 32 (1% of the total) are directly or indirectly foreign owned companies (64% of which are majority foreign owned companies).

- **When concerning foreign owned companies, do you have data on the country of the parent company and when were these taxpayers incorporated?**

This type of information can be captured on the annual returns (of income and accounting and tax information) which the taxpayers sent to the Portuguese Tax Authority in the year after each taxation period.

For instance, in 2016 the countries of the parent companies where these taxpayers are incorporated are in 70% of the cases other Member-States.

- **Of the total tax expenditure of 1.407.269,82 EUR of NID entitlement in 2016, how much is attributable to each of the above categories?**

See table at the end of the document

- **Please provide similar detail on data for years 2013 and 2014.**

See table at the end of the document

- **On the amendments to your regime, for which no data is yet available, could you please provide**
 - **an analysis of the policy underlying the measure, based on consultation documents, impact assessments or other sources prepared when it was introduced, and;**
 - **relevant statistical information, including for example, the estimated costs and/or benefits of the measure, the number of taxpayers expected to use it, etc.**

One of the constraints to the growth of investment, employment and GDP of the Portuguese economy is the high level of indebtedness of the enterprises, namely SME's.

Despite a gradual improvement of the credit conditions access to finance remains a major concern for SMEs.

In order to address this issue and speed up SMEs access to finance, to promote their capitalization and to strengthen their financial structures, Portugal's National Reform Program included measures to tackle corporate debt, namely through changes to the tax regime that reduce incentives to debt financing.

Please note that one of recommendations on the 2017 National Reform Program was that Portugal should take action in 2017 and 2018 to the Improve the access to capital, in particular for start-ups and small and medium sized enterprises.

TAX PERIOD	2013	2014	2015	2016
NUMBER OF BENEFICIARY COMPANIES	631	1440	2044	3299
NUMBER OF BENEFICIARY COMPANIES OWNED BY FOREIGN COMPANIES	0	7	13	32
PROPORTION OF BENEFICIARY WHICH ARE DIRECTLY OR INDIRECTLY FOREIGN OWNED COMPANIES	0,0% ^{a)}	0,5% ^{b)}	0,6% ^{c)}	1,0% ^{d)}
GLOBAL AMOUNT OF DEDUCTIONS TO THE TAXABLE PROFIT	1.300.948,36 €	3.503.749,40 €	4.903.392,39 €	7.532.554,60 €
TOTAL TAX EXPENDITURE	325.237,09 €	654.053,81 €	917.581,39 €	1.407.269,82 €
TAX EXPENDITURE ATTRIBUTABLE TO DIRECTLY OR INDIRECTLY FOREIGN OWNED COMPANIES	0,00 €	10.743,94 €	33.102,13 €	64.107,80 €
PROPORTION OF TAX EXPENDITURE ATTRIBUTABLE TO DIRECTLY OR INDIRECTLY FOREIGN OWNED COMPANIES	0,0%	1,6%	3,6%	4,6%
<p>a) None of the beneficiaries was a foreign owned company</p> <p>b) Only 7 beneficiaries are foreign owned companies, 3 of them are majority foreign owned companies</p> <p>c) 46% of which are majority foreign owned companies</p> <p>d) 65% of which are majority foreign owned companies</p>				

II / FINAL ASSESSMENT

[The following assessment was agreed by the Code of Conduct Group on 15 November 2018:]

Criterion	1a	1b	2a	2b	3	4	5	OA
Notional allowance for share capital								

Paragraph A of the Code of Conduct states that *"this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community.*

*Business activity in this respect also includes all activities carried out within a group of companies"*¹.

The general tax rate in Portugal is 21%. For small and medium-sized companies, a rate of 17% applies to the first 15.000 EUR of taxable income.

The interest deduction on equity (notional interest deduction, hereafter the "NID") was introduced in 2008 and amended in 2014, 2017 and 2018.

The NID base is limited to new cash share capital contributions up to 2.000.000 EUR made by shareholders, third party creditors or by retaining earnings for the purpose of the company's incorporation or increase of capital. The regime does not consider other increase of capital if they do not correspond to company's share capital cash contributions.

For the tax year 2017, the rate of interest deduction on equity is 7%.

According to the information provided by Portugal, this NID regime is mainly aimed at reducing indebtedness of Portuguese SMEs and, in this respect, the NID allowance can amount up to a maximum of 140.000 EUR (2.000.000 * 7%).

¹ 1 December 1997 ECOFIN Conclusions concerning taxation policy.

In order to avoid tax planning and abuse connected to notional interest regimes, the following limitations of the scope and anti-abuse measures have been identified in a previous assessment².

² Limitation of scope:

- Exclusion of own shares: this exclusion prevents the possibility for a company to increase its equity and simultaneously subscribe the new shares.
- Exclusion of shares held in other resident and non-resident legal persons: this exclusion tackles the possibility to cascade the ACE through chains of equity injection.
- The application of the allowance may not create nor increase tax losses. Consequently, a negative result due to this deduction does not generate a loss carry forward.
- Assets not necessary for conducting business: this is a classical exclusion in NID systems to avoid benefiting from NID on assets that do not generate taxable income (for instance, luxury goods, artwork, etc.).
- No deduction of NID with regard to capital which is allocated to a foreign permanent establishment. If the foreign PE was a legal person (a subsidiary), the parent company holding its capital would have to exclude those shares from the ACE base.

Anti-abuse rules targeting specifically transactions between related parties: The proposal for an EU Directive on a common consolidated tax base (CCCTB) contains an allowance for growth and investment (AGI). Art. 11(6) of the CCTB reads as follows:

“The Commission shall be empowered to adopt delegated acts in accordance with Article 66 to lay down more detailed rules against tax avoidance, and more particularly in the following fields relevant to the AGI:

- (a) intra-group loans and loans involving associated enterprises;
- (b) cash contributions and contributions in kind;
- (c) transfers of participations;
- (d) the re-categorisation of old capital as new capital through liquidations and the creation of start-ups;
- (e) the creation of subsidiaries;
- (f) acquisitions of businesses held by associated enterprises;
- (g) double-dipping structures combining interest deductibility and deductions under the AGI;
- (h) increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date.”

Portugal's Notional interest deduction rules include the following **limitations of its scope**: The regime covers only new share capital contributions. The maximum allowance is 140.000 € per company per year. The transfer of any kind of assets is excluded. Participations and foreign PE are not taken into account. The NID allowance cannot create losses. Excess amounts can be carried forward in accordance with the general rules of the Portuguese CIT Code.

Given the limitations of the scope, there is no need for **specific anti-abuse provisions** with regard to the transfer of participations, the re-categorisation of old capital, the creation of subsidiaries, the acquisition of businesses held in associated enterprises and the increase in the amount of loan receivables. Portugal has an anti-abuse provision to avoid cascading by intra-group loans (article 41-A(6) Estatuo dos Beneficios Fiscais (EBF)). Contributions in kind are limited to the conversion of shareholder loans occurring after 1 January 2017 or third party credits occurring after 1 January 2018 (article 41-A(2) EBF). Double dipping structures are neutralised or mitigated by a reduction of the limit on the deductibility of funding expenditure from 30% to 25% of the EBITDA, when a NID deduction is granted (article 41-A(5) EBF and 67(1)(b) IRC).

Portugal has a **general anti-abuse provision** (article 38(2) Portuguese General Taxation Law).

Based on the limited scope of the NID, Portugal has a robust combination of specific and general anti-abuse provisions which deal with the identified abusive cases.

Portugal provided the following data on the use of the NID regime since 2013:

Tax period	2013	2014	2015	2016
Number of beneficiaries	631	1440	2044	3299
Number of foreign owned beneficiaries	0	7	13	32
Global amount of NID granted	1.300.948,36€	3.503.749,4€	4.903.392,39€	7.532.554,60€

Total tax expenditure	325.237,09€	654.053,81€	917.581,39€	1.407.269,82€
Total tax expenditure applicable directly or indirectly to foreign owned companies	0€	10.743,94 €	33.102,13€	64.107,80€

From the 3299 taxpayers benefiting from the regime in 2016, only 32 (1% of the total) are directly or indirectly foreign owned companies (64% of which are majority foreign owned companies).

The amount of NID allowance granted to each of the 3299 companies that benefited in 2016 is, calculated as an average, of 2.283,28€ per company.

The average NID tax expenditure attributable to directly or indirectly foreign owned companies is $64.107,80\text{€}/32 = 2.003,36\text{€}$.

Considering these factual elements combined with the maximum NID allowance of 140 000 EUR, we are of the opinion that a NID regime such as the Portuguese regime cannot affect in a significant way the location of business activity in the EU, in the sense of paragraph A of the Code of conduct.

Therefore, the Code of Conduct Group considers this regime as being out of scope and that it should be subject to monitoring by the Commission services with regard to its economic effects.
