Exit Taxes

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1. Introductory and general aspects

Portugal includes in the taxation of income – besides the taxation on property and purchases – a natural person's income tax (IRS) and a corporate income tax (IRC).

On income tax, the difference is established, as usual around the world, between residents and non-residents taxpayers. Therefore, residents taxpayers are subject to taxation on the total amount of their income, including the ones obtained abroad ("obrigação ilimitada" - unlimited liability - articles 15.º no. 1º of the IRS Code and 4.º no. 1 of the IRC Code), while, relatively to the non-residents, their subjection only includes the income obtained in Portuguese territory ("obrigação limitada" - limited liability – articles 15.º no. 2 of the IRS Code and 4.º no. 2 of the IRC Code).

In order to be considered a natural person resident in Portuguese territory, by force of article 16.º no. 1 of the IRS Code, for the taxation year the income refers to, the following are required:

- that the person has remained in such territory for more than 183 days, consecutive or not;
- that, having remained for less than 183 days, the person has, by December 31st of that year, a place of abode from which his or her intention to maintain and occupy it as a regular residence may be posited;

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- that in December 31st, such person is a crew member of a vessel or aircraft, as long such entities pertain to companies with residence, seat or head office in this territory of Portugal;
- that he or she executes abroad public functions or commissions, in the service of the Portuguese State.

As regards the income realized in Portuguese territory, the criteria adopted were financial – residence of the taxpayer – and/or economic – location of the asset or of the activity from which the income derives (article 18.º of the IRS Code).

Regarding the IRC, taxpayers – including, besides corporations, entities without juridical personality status, e. g., vacant succession, corporate bodies whose incorporation has been declared invalid, associations and companies without legal personality, companies incorporated as commercial entities, before the final registration procedures are completed (article 2.º no. 1, line b, and no. 2) – are considered as residents when their seat (administrative headquarters) or head office (global administration of the company), respectively, are in Portuguese territory (article 2.º nº 3 of IRC Code). As to the criteria regarding the production of income in Portuguese territory, the same apply with reference to IRS: financial and/or economic criteria (article 4.º no. 3 of IRC Code).

2. IRS and transfer from national territory

2.1. Relatively to the transfer abroad, the IRS Code does not establish any taxation at the time of such exit, only a fictitious (!) maintenance of the status of resident in Portuguese territory.

Therefore, "people belonging to a household are always considered as residents in Portuguese territory, as long as one member of the household responsible for its management resides in the territory (article 16.º no. 2 of the IRS Code). However, due to difficulties created by such provision, specially concerning emigrants, an exception was introduced (article 16.º no. 3 of the IRS Code) and, now, that early provision may not be applied, in case of

- people who did not reside in Portuguese territory for more than 183 days, consecutive or not – in which case they are subject to taxation -, in the year which the income refers to,
- people prove that there is no link between the majority of their economic activities and the Portuguese territory.

In this case taxpayers will be considered taxable non residents, with respect to their income, which is considered as realised in Portuguese territory, in compliance of IRS Code.

After having ascertained the presence of said requirements, and by force of article 16.º no. 4 of the IRS Code, the spouse resident in Portuguese territory files a (single) income statement, comprising his/her personal income, his/her portion of joint income and the portion of income of dependents, according to the regime applicable to married people in the situation of "de facto separation".

It is also relevant to mention the legal fiction established on article 16.º no. 5 of the IRS Code that considers as still residing in Portuguese territory Portuguese nationals who transfer their residence in a country, territory or region, subject to a more favorable tax regime, according to the list provided by the "Portaria" of the Ministry of Finance,

unless they prove that such transfer is justified by valid reasons, such as the performance of temporary activities in the other territory for a Portuguese employer, as indicated as an example in the provision.

It important to note that the given example is quite inadequate, since it not understandable why the provision does not also include temporary activities if the mentioned entity is not resident in Portuguese territory.

And what if the residence transfer is not temporary? It would have been better for the provision not to present a specific example.

The above-mentioned list includes the countries usually referred to as tax haven or as law taxation zones, such as for example Andorra, Netherlands Antilles, Aruba, Bahamas, Bermuda Islands, Bolivia, Channel Islands

(Alderney, Guernsey, Jersey, Great Stark, Herm, Little Stark, Brechou, Jethou and Lihou), Cayman Islands, Cyprus, Costa Rica, Arab Emirates, Fiji Islands, Gibraltar, Honduras, Hong Kong, Jamaica, Jordan, Kuwait, Lebanon, Liberia, Liechtenstein, the Maldives, Isle of Man, Nauru, Panama, French Polynesia, Puerto Rico, Saint-Lucia, Seychelles, Swaziland, Tonga, Trinidad and Tobago, etc. (Portaria of Ministry of Finance no. 150/2004, of February 13th).

3. IRC and transfer abroad

3.1 For Corporations

3.1.1. On January 1st, 2006, a subsection was added to the IRC Code – subsection V-A under the title Transfer of a company's residence abroad and cessation of activity of non-resident entities -, to which a provision was also added, coming into force on 1st January 2007 (article 76.º-A of the IRC Code[2].

The provision regarding the transfer of residence includes

- obviously, resident entities, whose seat or head office are in Portuguese territory;
- the European Company and the European Cooperative Company.

The relevant fact is that

- the seat or head office are no longer in Portuguese territory, in other words, the residents are no longer residents.

In the provision

- the positive or negative components for the determination of the taxable income for the fiscal year when the cessation of activity has taken place are the differences between the tax relevant market and accounting value of the assets on the date of such cessation.

However, such provision has an exception and an extension.

[2] With the Code is not mentioned, we refer to the IRC Code.

3.1.2. Exception (article 76.º-A no. 2): it does not apply to the transferred assets

- which remain of pertinence of a permanent establishment of the same transferring entity, and which is situated in Portuguese territory; and
- contribute to the respective taxable income.

This as long as

- the transferred assets are registered in the respective accounting with the same values they had in the accounts of the company that is no longer resident;
- the referred values are the ones that result from the application of the IRC Code or from the appraisals done according to tax legislation (article 68.º no. 3, lines a and b).

In this case and according to article 76.º-A no. 3, the determination of taxable income of the permanent establishment which has been created must comply with the following rules:

- the calculation of the income regarding the transferred assets is done as if there were no transfer of residence;
- the reintegration or amortization on items of the transferred fixed assets are made according to the same regime that was followed by the transferred company;
- the transferred provisions have, for tax reasons, the same regime that was applied before in the transferred company;
- tax losses assessed before the cessation of activity may be deducted from the taxable income allocated to the permanent establishment of the non-resident entity, as long as they correspond to the respective assets and as long as it is duly authorized by the "director-geral dos impostos" -tax general-director, through a request presented by the entity itself by the end of the month following the date of activity cessation, showing the pertinence of the loss in connection with the activity carried out by the permanent establishment.

However, this exception is not applicable – which means then that the general rule does apply, according to the article 76.º-A no. 5 - in the cases when it has been assessed that operations, as per the above, had as main scope or as one of their main scopes tax evasion, which is considered the case when

- the total income is not subject to the same regime applied to the taxation by IRC;
- operations have not been executed according to sound economic reasons, such as reorganization or the rationalization of the company's activities,
- cases in which the additional settlement of the tax may proceed.

3.1.3. But, besides the mentioned exception to the rule – rule according to which, as we have seen, the positive and negative differences between the tax relevant market and accounting values of the assets, on the cessation date, are relevant for taxation -, there is an extension of the rule: its application, with the necessary adjustments, covers the determination of taxable income of a permanent establishment located in Portuguese territory of the non-resident company. The conditions to such an extension are

- the cessation of the activity in Portuguese territory;
- the transfer abroad, physically or legally, of the assets related to the permanent establishment.

This situation results on the impossibility to avoid taxation by successive transfer of assets related to the establishment.

3.2 For partners

The transfer of the seat or head office has tax consequences not only concerning the legal personalities, but also the partners. Relatively to the latter, the rules are not applicable in case of transfer of the seat of the

European company or of the European cooperative company. Besides this exception, regarding partners' taxation, the difference between the net equity on the date of the transfer is taken into consideration– the appraisal of the assets is done by taking into consideration the market value (article 76.º-C no. 2) – and the acquisition price that corresponds to the respective equities, applying, by force of the article 76.º-C no. 1. There is also a special discipline for the companies covered by the transparency regime (article 75.º n. 4, by force of the article 76.º-C n1) according to which in computing said difference the following should be applied:

- this difference, when positive, is considered as income of capital investment until the limit of the difference between the attributed value and the one that from the accounts of wound-up company, corresponds to the effectively realised income, and considering the possible excess as taxable capital gain (article 75.º no. 2, line a, by force of article 76-C no. 1);
- this difference, when negative, is considered a depreciation, deductible only when equities were owned by the taxpayer during the three years immediately before the date of the transfer (article 75.º n. 2, line b), by force of article 76.º-C no. 1).

In case of taxation of the difference considered as income derived from the capital investment with respect to line a above, by force of article 75.º no.3, the provisions regarding the avoidance or mitigation of double taxation (total deduction of the income included in the tax basis, corresponding to distributed profit, as long as the participation responds, among others, to the requirements of participation in the company's capital in term of percentage, value or time, or in other cases, deduction of only 50% of the income included in the tax basis corresponding to distributed profit) are applicable.

4. The Community Law

4.1 The problem of the “Exit taxes”

The problems regarding the “exit tax” is strictly connected with the free circulation of production assets: freedom of exit and freedom of entry (articles 43.º and 48º of the Treaty). The freedom of establishment constitutes a fundamental principal of the European Union (article 43 of the Treaty) and such freedom includes the right “to take up and pursue activities as self-employed persons and to set up and manage undertakings under the same conditions as are laid down by the law of the Member State of establishment for its own nationals” (Ruling of November 5th, 2002, Case ÜBERSEERING, C-208/00, no. 56, mentioned in Ruling of December 13th, 2005, Case SEVIC, C-411, no. 17 and 18) or to acquire the total amount of shares, allowing to determine the activities of the respective companies – in others cases the free movement of capital will be applicable – (ÜBERSEERING no. 77, and, in general, to natural persons, Ruling of September 7th, 2006 N, Case C-470/04, no. 26). That means that national treatment in the Country of destination must be the same for residents and non residents, but also that hurdles nor impediments should be created to the exit of nationals from the Country of origin. The same principles apply to companies created in accordance with the legislation of a Member State by putting in the same level the natural persons who are nationals of a Member State and the companies which have their registered office, its actual centre of administration or main place of business within the European Union (ÜBERSEERING no. 56 and 75). After affirming in abstract – not exactly in the case sub judice – the impossibility due to EC Law for a Member State – in general terms, under commercial law – to prevent the establishment of its companies in another Member State (Ruling of September 27th, 1988, DAILY MAIL GENERAL TRUST, Case 81/87, no. 16, with the same reasoning, Ruling of July 14th, 1994, MATTEO PERALTA, p.º no. 379/92 no. 31). Also, with respect to the freedom to provide services, it should be remarked that said freedom finds obstacle in the application of a national law which "creates more difficulties to the providing of services of services between Member States than the merely internal providing of services in a Member State (Ruling of October 5th, 1994, COMMISSION / FRANCE, C 381/93, no. 17). These two sides of this aspect are clear when it is stated that: "It should also be pointed out that, even though, according to their wording, the provisions concerning freedom of establishment are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Article 58" (Ruling of July 16th, 1998, ICI, C-264/96, no. 21, quoting Case DAILY MAIL AND GENERAL TRUST). This position is also clear in the Judgment of November 18th, 1999, X AB and Y AB no. 26, quoting Cases DAILY MAIL and ICI, in which a company was penalized for its subsidiaries abroad. And the same can be found in Ruling of April 13th, 2000, C BAARS, P.º no. 251/98, no. 28, quoting previous judgments, and also in the ruling of December 14th, 2000, AMID, C-141/99, no. 21, with case law quotation (in particular with reference to exit, ruling of November 21st, 2002, X and Y, C-436/00, no. 37 and 38).

To the specific case of taxation derived from exit, see Case HUGHES DE LASTEYRIE DU SAILLANT, whose ruling on March 11th, 2004, C-9/02, no. 42, clearly established that said provision was unacceptable when referring to natural persons.

Moreover, the prohibition to increase tax burdens in case of exit also includes the contributions to social security, according to Case TERHOEVE, with ruling on January 26, 1999, file C-18/95, in which it is pointed out that: "Provisions which preclude or deter a national of a Member State from leaving his country of origin in order to exercise his right to freedom of movement therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned" (no. 39, quoting Case C-10/90 MASGIO V BUNDESKNAPPSCHAFT, no. 18 and 19, and BOSMAN, Case C-415/93, no. 96).

4.2. Possible derogation

May the freedom of establishment be revoked by rules destined to avoid tax evasion derived from the exit? Do hardship clauses within some European Directives lead to an affirmative answer? The decisions taken by the European Court on cases concerning exit taxes, along with the case law on abuse of the Law, lead to a negative answer (ICI, no. 26, and X and Y, no. 62; on the decision of September 12th, 2006, CADBURY SCHWEPPES, C-195/04, no. 36, it is clearly mentioned that tax advantages, themselves, do no imply an obstacle to the relocation or transfer). It is obvious that we are making reference to the situation in which, in the State of destination, the company is taxed according to the regime established there for all legal personalities, as no "ring fencing" regime is established, since in this case the provisions of the Code of Conduct – integrating principles of the soft law - would apply. We would enter then into a case of harmful tax practices.
Therefore, in the above-mentioned case, the possibility to invoke the limitations to the freedom of establishment stated by the EU Treaty (article 46.º) – such as public order, security or public health reasons - is not applicable nor do the limitations established by the jurisprudence (EU Court). According to such jurisprudence (cases HUGUES DE LASTEYRIE DU SAILLANT, no. 49, N, no. 40, INSPIRE ART. no. 133 and SEVIC, no. 28 e 29), the freedom of establishment, present in articles 43 and 48 of the Treaty, might be mitigated only when such restriction:

- is justified by virtue of imperative reasons of general interest that do not include loss of tax revenues (ICI no. 28);
- seeks a legitimate scope, compatible with the Treaty;
- is adequate to the scope looked for;
- respects the proportionality principle;
- is no applied in a discriminatory way;

- is imposed for tax coherence (Ruling of January 28th, 1992, BACHMAN, C-204/90, n.ºs 22, 23 and 27; Commission / Belgium, C-300/90, n.ºs 20 and 21; in terms of exclusion of application, see ruling of August 11th, 1995, WIELOCKX, C-80/94, no. 24; ruling of September 18th, 2003, BOSAL HOLDING, C-168/01, no.s 29 and 30 and ruling of September 7th, 2004, MANNINEN, C-319/02, no. 42).

5. Comparison with Portuguese Tax Law

5.1 Regarding individual taxpayers

The IRS Code does not establish, as previously said, exit taxes, but there are two provisions that produce a restrictive effect when people transfer abroad but are still considered as residents, although such a fiction may be avoided (for example, in the cases of seasonal emigration). These provisions affect the global tax situation of the taxpayer as they are not limited to any category of assets in particular. On the other hand, one of these rules is applicable only to Portuguese taxpayers, which results in a reverse discrimination for non nationals, although there is no distinction between the Member States and the non-member States of the European Union.

According to the orientation of EC case law (cases LASTEYRIE DU SAILLANT and N), there is no direct conflict between Portuguese law and relevant EC Laws. However, it may be questioned whether the maintenance of the residence status does entail a dissuasive effects on the taxpayers that truly wish to establish themselves in another Member State. In fact they would be subject to the status of residents for tax purposes both in Portugal and in the Country of destination– as there is no Convention on double taxation and despite unilateral decision taken by individual Member States. Therefore, nationals transferring abroad would receive a possibly

disadvantageous treatment in comparison to a national who maintains his or her residence in Portugal and is a resident only in Portuguese territory.
The problem of presenting a guarantee is not envisaged in said events, although in specific circumstances the designation of a representative is required. However, there is still a constraint on the freedom of movement, due to the difficulties to avoid the application of what Portuguese law establishes.
And it cannot be sustained that the purpose is to avoid tax evasion, which is of no relevance in this case. Also, in accordance, as written before, with the EC case law, general provisions cannot be introduced, but the circumstances of the individual case should be examined. This would take place when provisions are applied to all cases with the same characteristics, independently from real or even apparent intentions. In other words, the change of residence should no imply a real or potential increase in the global taxation.
This is different from the cases related to partners of migrant companies. In these cases, an exit tax has been introduced, in the indicated terms, with all the consequences at EU level

5.2 Discipline applied to corporate taxpayers

5.2.1 Before analyzing the conflict between Portuguese tax rules and EU orientation, we will make reference to some aspects of the Portuguese commercial law.
Assuming that, the term “seat” is used with the meaning of the “headquarters” or “main office” of a company, Portuguese law considers as the governing law which is applicable to a company «the law of the State where the main and effective seat of its administrationis located » (article 3, no. 1, of the “Código das Sociedades Comerciais” - Commercial Companies Code -, hereafter indicated as CSC).
If a company transfers its effective seat from another country to Portugal, article 3, no. 2, of CSC provides that the legal entity shall be maintained, if

the law of the Country of origin allows that but the company's by-laws must be adapted to Portuguese law.

Similarly, the Portuguese law permits the transfer of the seat of a company incorporated in Portugal to a foreign country. In fact, article 3, nº. 5, of CSC provides that: «A company having its effective seat in Portugal may transfer it to another country, keeping its legal entity, if the law of that country so allows» (3).

Consequently, in the Portuguese law the transfer abroad of the seat of a company incorporated or established in Portugal does not determine the winding up of the company.

The sole requirements of the transfer of the seat of a company to another country are those mentioned in nº. 6 of article 3 of CSC, as follows: «The deliberation of transfer of the headquarters, with reference to the item above, must comply with the requirements for the modification of the company's by-laws, and it shall be adopted with at least 75% of the votes corresponding to the share capital. The partners who have not voted in favor of the deliberation can resign from the company and for this purpose they shall notify of their decision by 60 days after the publication of the deliberation» (4).

In view of what has been stated above, there is no problem of compliance with EU Law.

The Portuguese CSC was published and later updated after Portugal became a Member State of EU, and the provisions with EU Treaty and Directives, including the Merger Directive (no. 78/855/CEE, of October 9th, 1978, in JO L 295, of October 20th, 1978) have been taken into consideration in drafting.

As CSC broadly permits the transfer of companies' seat, it appears as fully compliant with the principles of EC Treaty and EC derived Law provisions, namely those regarding the matters mentioned in this question.

[3] This is a free and not official translation of the legal provision.
[4] This is a free and not official translation of the legal rule.

In the situation of transfer of a company's seat to Portugal, the legal and judicial capacity of the company is recognized. The same is true for the case when a company is purchased by residents of the State where its seat was transferred.

In Portuguese Law, also, the reasons why a company chooses to be formed in Portugal or in another country are irrelevant , save in the case of fraud, with regard to application of the provision on freedom of establishment (ruling of September 30th, 2003, INSPIRE ART LTD, C-167/01, no. 95 and 96).

In any case, Portugal retains the right to take action against the so-called *caixas de correio* “brass-plate” in which case there is a lack of any real connection with the State of incorporation” (INSPIRE ART LTD, n.º 102). However, the simple fact that the company does not execute any of its activities in the State where it was incorporated does not constitute abuse of the right of establishment (ruling INSPIRE ART LTD, no. 95 and 96) and the same can be said when the company is established in a particular Member State for the sole purpose of taking advantage of more favourable tax regimes (no. 121 and 138).

5.2.2. Therefore it has been verified that the principles established by the EC case law in the case of individual’s taxation must also be applied to companies, in view of the wide scope assigned to the principle of freedom of circulation of production factors. In the understanding of the EU Commission (COM (2006) 825 final), the freedom of establishment also implies the non taxation in case of the transfer of assets to a permanent establishment located in another Member State, thus avoiding in any case a different treatment from what would apply in the case of an internal transfer (the Commission admits, however, a deferred taxation or payment).

6. Conclusions

From the analysis of the Portuguese Law, it results that the cases "multi-located" legal personalities, are disciplined as follows:

- the transfer of residence abroad from Portugal, maintaining or not maintaining permanent establishment in the territory of the State;
- the total or partial transfer to another country of the permanent establishment of a company which is not resident in Portuguese territory.

In those situations, only the first one does not imply taxation, with respect to assets not transferred, in case of transfer of residence (seat and head office) to another country, provided that the activity in Portugal is maintained by a permanent establishment: In this case the assets that contribute to profit creation will not be taxed, as long as some requirements are observed.

It is important to bear in mind the implications resulting from the transfer of the seat and head office of the company for the partners, even in case there is a permanent establishment still present in Portuguese territory.

The same provision, abstracting these last effects to the partner, also apply to the case of transfer of the seat of the European Company or the European Cooperative Company. As for the losses, however, the general rules applicable to the companies that do not transfer their seat will not be automatically applicable to these cases, since a previous authorization is required. Considering that the principles applied on the case HUGHES DE LASTEYRIE DU SAILLANT are applicable to the assets transferred by companies –for the reasons already illustrated -, there is therefore a tax at the time of *"exit"* not only in case of transfer of residence, by also in the cassation of the activity of the permanent establishment of a non-resident, or for the transfer abroad of assets related to the permanent establishment.

That means that there is a difference in the treatment applied to each case, because, for example, "critério da realização", the criterion of "the realization", normally applied to taxation on capital gain is, in case of "exit", sostituted by "critério do acrescido", the criterion of "growth"; That affects the freedom of establishment.

In order to avoid such consequence, it should be determined, and in accordance with the Commission's orientation, that neither the taxation should be applied according to the "critério da realização", nor to the deferred taxation, in case taxation is subject to some conditions, except for the obligation to disclose regularly the financial status and always taking into consideration the principle of proportionality. It may be envisaged that a declaration should be presented at the time of transfer, attesting that there was no transfer of assets, as well as an annual report summarising the situation at the time of each of these declarations, and, finally, another declaration in the time of selling. All these declarations could be controlled by activating the mechanisms of tax assessment and, if necessary, the mechanisms of collection, at European level. Also, and following what has been suggested by the Commission, a tax regime could be established providing for the freedom to choose between deferred taxation and taxation at the moment of the transfer.

After analyzing the application of the aforesaid jurisprudence and the Commission's orientation, it may be inferred that the Portuguese legislation should be modified in order to avoid taxation on unrealised values at the time of the transfer.

The reservations concerning these solutions stated by the Commission with respect to the EEA as well as other (non member) countries are understandable, in view of reduced effectiveness of guarantees regarding tax collection at the time of the actual disposal of the assets.