January 2015

Portuguese personal income tax reform

An overview of the most relevant measures

Law 82-E/2014 of 31 December enacts the Portuguese reform of the Personal Income Tax (in Portuguese - *Imposto sobre o Rendimento das Pessoas Singulares or IRS*).

The Law is largely based on the recommendations incorporated on prior Reports by the Commission for the Personal Income Tax Reform appointed earlier last year.

The Commission mandate was focused on 3 vectors: (i) tax simplification, in particular focusing on reporting obligations; (ii) enhancing social mobility, in particular regarding employment income; (iii) protection of family, in particular by strengthening family tax policies. The reduction of the tax burden was not included on the mandate, although some of the measures included on the Law pave the way to a reduction albeit shy of the overall tax burden on individual Portuguese tax residents.

The most relevant areas of interest of this Law include:

- Changes to the tax residence definition
- Tax treatment of school vouchers and other fringe benefits
- Exemption for assignments to work abroad
- Changes to the tax base of rental income
- Revamp of investment and capital gains income categories
- Option to aggregate income and tax at progressive rates
- Changes to separate taxation and joint taxation and the family coefficient
- Progressive tax rates for 2015
- Tax credits for 2015
- Deadlines for the submission of tax returns

The Budget Law for 2015 (Law 82-B/2014), Law amending CIT (Law 82-C/2014) Green Tax Reform (Law 82-D/2014) were also published on 31 December and the measures contained on those legislative packages will be covered on a separate overview.

Garrigues tax team looks into the most relevant tax measures of the Portuguese personal income tax reform, which will generally apply as from 1 January 2015.

1. Changes to the tax residence definition

Under the rules in place until 2015, domestic tax residence was fulfilled either by exceeding the 183 day test of physical presence in Portugal or by holding on 31 December a dwelling that implied an intention of maintaining and using such dwelling as a permanent home.

The Law maintains the first 183 day test but clarifies that those 183 days are counted in any twelve month period commencing or ending in the calendar year concerned (part of a day included). The second permanent home test is also slightly altered to consider resident in Portugal those that even when staying less time than the 183 days, have at any time of that period a dwelling that implies intention of maintain and use as a permanent home.

The two additional residence rules for international traffic crew members and Portuguese diplomatic personnel remain unchanged.

The Law set out that day of arrival is the first day for purposes of being considered resident in Portugal (no longer the civil year as reference).

The loss of tax resident status occurs from the last day of staying in Portuguese territory unless the person is present in Portugal more than 183 days on departure year or derives after the day of departure any Portuguese source income that would otherwise be subject to tax.

If a resident leaves Portugal and returns within a year, that person will be deemed Portuguese tax resident for the prior year. The Law also provides a rule providing that domicile (address communicated to tax authorities) is deemed to be the permanent home, unless proven otherwise.

Garrigues Comment: The new rules may affect companies with inward and outward expatriates during a taxable year. The proposed changes simplify some issues namely on the entry date for inward expatriates but some concerns on exit situations remaining, as tax controversy issues on the current tax residence rule and interaction with tax treaties tie-breaker rule may continue to be a problematic topic.

2. Tax treatment of school vouchers and other fringe benefits

The Law extends of the age of dependents (from 7 to 25 years old) for which is currently allowed the attribution of the so-called corporate "school vouchers" granted to parents for payment of school fees. The expense of the school vouchers will be fully deductible income at the level of the employer and under certain circumstances (and limits) will not give rise to taxation at the level of the employee.

The Law also increases of the thresholds for exclusion of taxation as fringe benefit of interest-free loans or loans at interest rates below a benchmark rate granted by the employer to acquire a permanent home of the employee.

Garrigues Comment: These extensions are likely to raise further interest from Portuguese based companies to increase the use of these fringe benefits on the remuneration package of employees.

3. Exemption for outbound expatriates performing work abroad

The Law establishes an exemption for employment income capped at €10.000 earned by tax resident individuals for short term assignments whereby the individual moves their usual work place abroad for a period not less 90 days (of which 60 days consecutive) and receives any compensation for travel and stays abroad exceeding the exempt daily allowances for business travel under the current PIT Code. This regime operates as an exemption with progression. The exemption also applies also to non-resident taxpayers that have moved abroad (with a limit of 3 years from the date of assignment).

For domestic situations, the Law establishes that employer compensations for the transfer of domicile due to the change of work place (within Portugal) are set to be excluded from taxation up to 10% of annual compensation, with a limit of €4.200. This income exclusion applies to compensations paid only once every three years.

Garrigues Comment: The new measure for cross-border short-term assignments is welcomed but may be considered to fall short in terms of value of similar European regimes.

4. Changes to the tax base of rental income

The Law clarifies qualifying expenses deductible against gross rental income, to recognize for tax purposes conservation and maintenance expenses incurred on the 24 months preceding the start of the rental agreement if the property has not been used for any purpose other than the lease (only for expenses as from 2015 onwards).

Additionally, the Law also provides that leasing of immovable property be considered as a professional activity for PIT purposes in case the individual opts for taxation as business profits.

Garrigues Comment: These measures - together with last year application of flat 28% rate to rental income - are designed to improve tax treatment of individuals deriving rental income and represent an "equalization" with the taxation of other items of income.

5. Revamp of the investment income and capital gains categories of income

The Law provides a revamp of the items of income falling under investment income (Category E) and capital gains (Category G). The main changes include:

- Repayment of debt securities. Under the rules applicable until 2015, the repayment of debt securities is categorized as investment income for Portuguese PIT purposes subject to progressive rates and extraordinary surcharges The Law establishes that repayment of debt securities upon maturity qualify as an onerous transfer of securities and therefore any gain derived therefrom shall be categorized as a capital gain subject to a final 28% rate.

- Redemption of units in funds and liquidation proceeds. Under the rules applicable until 2015, redemption of units in funds and proceeds derived from the liquidation of investment funds are categorized as investment income. As the Portuguese investment funds are (currently) taxable entities in Portugal, the structure of the system is to exempt the income when distributed/redeemed to the individual. Inversely, income derived from foreign funds is subject to progressive rates at investor level. This categorization changes under the Law and thus the redemption of units and proceeds derived from the liquidation of investment funds shall be qualified as capital gains. As a consequence of these proposed amendments, income derived from Portuguese investment funds will be exempt at the level of the individual, whereas income derived from foreign funds shall be taxed at 28% (not subject to withholding tax mechanism).

- Swap and exchange transactions. Under the rules applicable until 2015, gains arising from foreign exchange swaps, interest rate swaps, combined interest rate and currency swaps and forward foreign exchange contracts qualify as investment income and are subject to a 28% flat withholding tax rate. Under the Law, interest rate swaps maintain their current qualification as investment income, whereas foreign exchange swaps, combined interest rate and currency swaps and forward foreign exchange contracts shall qualify as capital gains subject to a final 28% rate (although not subject to withholding tax mechanism).

- Autonomous warrants. Under the rules applicable until 2015, Portuguese PIT Code provides a limited set of rules dealing specifically with the taxation of income derived from autonomous warrants. The Law foresees new rules on the autonomous warrants, namely covering the transfer before the exercise of the warrants, the possibility to off-setting losses and gains computed within the same fiscal year and determination of the acquisition cost.

- Fiduciary structures. Under the rules applicable until 2015, there were no express provision covering income derived through trusts and other fiduciary structures. The Law provides for; (i) recognition over the value assigned as a result of the liquidation, termination or cancellation of fiduciary structures as capital gain or loss; and (ii) any income made available or paid through fiduciary structures (unless referring to the wind-up of the trust or income already been taxed under the CFC rules) qualifies as investment income and therefore is subject to a flat 28% rate (unless sourced in blacklisted jurisdictions – subject to 35%).

- Extension of aggravated rates. The Portuguese PIT Code already provides for the application of an aggravated 35% final and special withholding tax rate on investment income obtained from or paid to a blacklisted jurisdiction. Furthermore, an aggravated 35% withholding tax rate also applies when Portuguese income is paid or made available by a local paying agent to accounts opened in the name of one or more account holders on behalf of undisclosed third parties (omnibus accounts), unless the beneficial owner is identified. The Law foresees the extension of the aggravated 35% tax rate for gains derived from: (i) fiduciary structures domiciled in blacklisted jurisdictions and (ii) repayment/redemption of bonds, debt securities units of funds when the issuer is domiciled in blacklisted jurisdictions.

- New rules for computation of capital gains. The new Law establishes the recognition of indexation relief coefficients (applicable currently to real estate transfers) to the purchase price of shares/securities when it exceeds 2 years between acquisition date and disposal date. Furthermore, the Law establishes that the necessary expenses connected to the acquisition and disposal of shares/securities will be recognized for purposes of calculating the capital gains (currently only the disposal expenses are recognized).

- Carry forward of Capital Losses. Under the new Law, capital losses may be offset against gains realized in the following 5 years (previously 2 years) without requiring the individual to aggregate all other income (from different income categories) derived in that fiscal year - thus allowing offset of gains and losses within the same income category. There is a transitory provision stating that the new rules of 5 year carry forward only apply to capital gains and losses realized as from 1 January 2015 onwards.

- Long term savings incentive. The Law establishes an incentive to long-term savings (5 year term deposits or investments) through the application of a favorable tax regime, whereby (i) one-fifth of the investment income is excluded from taxation if the withdrawal of the deposit or investment occur between the fifth and eighth year of the contract (effective rate of 22,4%) and (ii) three-fifths of such income is excluded from taxation if the withdrawal occur after the eighth year of the contract (effective rate of 11,2%).

- 28% tax rate applicable to investment income and capital gains will be identical to both resident and non-resident taxpayers. Foreign investment income or capital gains not subject to Portuguese withholding tax (because not paid by a local paying agent) will be liable to 28% rate regardless of the type of investment/gains derived.

- Special tax of 60% on unjustified windfall gains is eliminated.

- Clarification that the Portuguese paying agents of foreign income are not obliged to withholding tax in the case of exempt income paid to non-habitual residents.

Garrigues Comment: The changes outlined are some of the more far reaching changes provided by the Law and may impact considerably the taxation of financial portfolio of resident individuals. The changes concerning the 28% flat rate are designed to correct inconsistencies of the current rules.

6. Option to aggregate income and tax at progressive rates

The Law provides that the current option available to aggregate income subject to withholding tax at flat rates (28%) and tax them at progressive rates may be applied limited within each income category (i.e. only results on the aggregation of all income of that category the individual opted to be taxed at progressive rates).

Garrigues Comment: The changes are also welcomed (especially when complemented with extension to 5 years of carry-forward of capital losses) because prior rules to aggregate were in most cases not positive due to the inability to cherry-pick the income category, namely for cases where progressive rates would be more beneficial than the flat 28% rate.

7. Changes to separate taxation and joint taxation and the family coefficient

The rules applicable until 2015 provided for mandatory aggregation of all incomes in a family unit (joint taxation). The new Law establishes that separate taxation for married taxpayers (or de facto unions) becomes the norm with the option being available for joint taxation. The main changes for 2015 include:

- Recognition of dependents up to 25 years of age and of de facto unions initiated prior to taking up residence in Portugal (subject to evidence of the cohabitation).

- Specific rules for the allocation of income and deductions for dependents between the two spouses in case of separate taxation.

- Tax residence will be assessed for each taxpayer (currently the family unit).

- Replace the income-splitting system - which allows couples to divide their combined income by 2 for the purpose of applying the progressive rates and then double the tax liability – by a family quotient under which each taxpayer is granted a factor 1 and each dependent the factor 0,3 or 0,15 (for couples that opt for separate taxation).

- Cap the amount of tax payable saved by considering dependents in the family quotient to certain thresholds - between €300 and €2000 per family or taxpayer depending on number of dependents and option for separate or joint taxation.

- For 2016 and 2017 (subject to assessment of impact of these measures) it is proposed to increase the family quotient to 0.4 and 0.5 and increase the caps of reduction of tax payable by 12.5%.

Garrigues Comment: This topic is perhaps one of the major points of innovation of the Law and it is expected to give rise to complex calculations on which of the options available is the most suitable for each specific case.

8. Progressive Tax rates for 2015

Progressive rates schedule up to 48% is maintained to all income not subject to final withholding tax or flat rates.

Additional income tax will be also due on the part of the taxable income (not taxed at flat rates) exceeding €80.000 as follows: (i) 2.5% on the part of the taxable income exceeding €80.000 up to €250.000 and (ii) 5% on the remaining part (if any) of the taxable income exceeding €250,000.

For 2015, the 3.5% extraordinary surtax will also be maintained (subject to refund if PIT and VAT revenues exceed a certain threshold).

Garrigues Comment: The maintenance of the progressive tax schedule for 2015 is an indication that the past tax-hikes resulting from the budgetary adjustment programme remain in place. An innovative compromise was achieved to condition the refund of the extraordinary surtax in 2016 to the good performance of PIT and VAT government revenues.

9. Tax credits for 2015

Traditionally the Portuguese personal income tax has provided for a myriad of tax credits against the tax due which in the last years were very limited to taxpayers on the higher brackets. The PIT Law provides major changes to the tax credits as summarized on the following table:

Personal and family tax credit	Tax credit for each dependent of € 325 (add € 125 for each dependent with less than three years old).
Family expenses	35% of expenses capped at € 250 for taxpayer, with the acquisition of goods and services (except health expenses). The limit is 45% capped at € 335 for single-parent families.

Health expenses	15% of expenses capped at € 1,000 for taxpayer, with the acquisition of health related goods and services either VAT exempt or subject to reduced VAT rate.
Education and training expenses	30% of expenses capped at € 800 for taxpayer, with the acquisition of services education and training related.
Housing interest or rent expenses	15% of expenses with limits depending on taxpayers taxable income.
Credit for invoices of specific sectors	15% of VAT incurred capped at €250 included on invoices communicated to the tax authorities regarding certain provision of services of specific sectors of activity (e.g. restaurants).
Retiring home expenses	25% of the expenses capped at € 403,75 incurred with homes and institutions to support the taxpayer, ascendant and relatives until the third degree who do not have income equal or above the minimum monthly wage
Alimony payments	20% of the amount paid with limits depending on taxpayers taxable income (with those payments being taxable at a 20% rate on the beneficiary level).

Excluding family expenses and other tax credits, the sum of tax credits is capped to different limits (e.g. €1000 for taxpayers in the higher bracket) depending on whether or not married couples, or unmarried couples living on the same fiscal address, have filled joint or separated tax returns, and also on the number of dependents.

The amount of tax credits as from 2015 will be determined by the tax authorities on the basis of invoices communicated electronically by each issuer up to 15 February of the following year.

Garrigues Comment: The changes to tax credits are also a major topic of the Law and should be viewed in the framework of the extensive work of the Portuguese tax authorities to disseminate electronic invoicing (now linked to tax credits) and innovate by setting prizes to consumers who require invoices on purchases of goods and services.

10. Deadlines for the submission of the tax returns

The Law provides the standardization of the deadlines for the submission of the tax declarations - 15 March to 15 April for employment and pension income and 16 April to 16 May in all other cases. The Law also includes an extended deadline up to end of year for taxpayers who derived foreign income abroad and are entitled to a double tax relief and the source state did not yet assess the final tax. Threshold for the need for filing tax return will be increased to €8.150.

Garrigues Comment: This simplification measures are welcomed together with other related measures covering reduction/reshuffling of certain tax declarations on employers.

11. Other relevant proposals

The Law provides for further changes, including measures affecting:

- Review of limited exit tax mechanism applicable in Portugal to unrealized gains resulting from tax neutral exchange of shares and contribution of business by individuals.
- Widening of the 50% exemption of dividends (applicable upon option to tax at progressive rates instead of 28%) to EU/EEA source dividends.
- Review of the juridical double taxation credit mechanism and introduction of a 5 year carry-forward of unused foreign tax credits.
- Changes to professional and business income (Category B).

For more information or if you wish discuss in detail any issues related to this alert, please contact your local Garrigues professionals.

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