THE CORPORATE TAX PLANNING LAW REVIEW

SECOND EDITION

Editors
Jodi J Schwartz and Swift S O Edgar

THE LAWREVIEWS

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PUBLISHER
Tom Barnes

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PREFACE

We are pleased to present the second edition of *The Corporate Tax Planning Review*. This volume contains 22 chapters, each devoted to a different country and each providing expert analysis by leading practitioners of the most important aspects of tax planning for multinational corporate groups in that country, with a particular focus on recent developments.

The jurisdictions represented in this volume are diverse and include established major economies (e.g., the United States, Germany, Korea, etc.); EU countries both that have become popular destinations for new business organisations and those where multinationals tend to form entities to facilitate local operations or investments; the city states of Singapore and Monaco; and several nations in the Global South (Colombia, Venezuela, Malaysia and more). Echoing this geographical variety, *The Corporate Tax Planning Review* describes tax developments worldwide that respond to different challenges in different places. At the same time, many countries share goals of preventing jurisdiction-shopping, protecting against erosion of the tax base, promoting local investment and raising revenues. These complex and at times conflicting goals present opportunities for the well advised and traps for the unwary.

While each chapter discusses issues at the cutting edge of tax law, the authors have contextualised their analyses with sufficient background information to make this volume accessible and useful to generalists and to tax practitioners outside each particular jurisdiction. Although *The Corporate Tax Planning Review* is by its nature an abbreviated overview, we hope it will at least serve as a workable compass to in-house counsel and outside advisers as they attempt to navigate their clients through the unsteady and at times uncharted waters of contemporary corporate tax planning.

We are extremely grateful to the contributors who have assiduously distilled a wealth of expertise to create this volume and to Nick Barette, Gavin Jordan, Tommy Lawson and Adam Myers at Law Business Research Limited for their editorial acumen and dedication to this project.

Jodi J Schwartz
Swift S O Edgar
Wachtell, Lipton, Rosen & Katz
New York, NY
April 2020

Chapter 15

PORTUGAL

António Rocha Mendes[1]

I INTRODUCTION

The Portuguese economy did not emerge from the global financial crisis until 2014. Although GDP since then has been consistently growing, the reality is that the current pandemic crisis caught the Portuguese economy still in the process of restructuring. Banks were still dealing with bad loans and corporates were still restructuring their balance sheets. The financial sector went through a profound reorganisation. All national banks, with the exception of the state-owned bank, have been acquired by foreign banks or were restructured (including the biggest private bank). Several of the biggest corporates went into bankruptcy or simply sold most of their businesses (including the largest telecommunications company).

For this reason, in recent years, most of the relevant transactions in the market have involved the acquisition of financial institutions and mid-size companies, as well as the debt restructuring of some of the largest companies in Portugal, in particular industrial groups, concessionaires and PPPs. Most of the capital was provided by international investment funds. For this reason, tax planning essentially involved advice on setting up tax-efficient acquisition structures and dealing with the tax implications of the several Chapter 11 procedures available for debt restructuring.

On the other hand, the fastest-growing economic activity in recent years has been tourism, which currently represents 14 per cent of GDP. This growth and the enactment of a special tax regime for new residents, which in the past seven years has attracted 30,000 new residents (mostly tax expatriates from France and Brazil), sent property prices soaring and attracted the interest of several international investors. Advisers involved in tax planning have mostly been dealing with real estate acquisition structures tailored for these new market players.

In Section II we describe general background rules that were relevant for the investment structure decisions by these foreign investors. In Section III, we describe the main types of transactions and the challenges that were faced from a tax-planning perspective.

II LOCAL DEVELOPMENTS

i Entity selection and business operations

The large majority of business ventures take the legal form of incorporated commercial companies, namely private limited liability companies (Lda) or corporations (SA). The former is by far the most common type of business entity. The Lda's share capital is divided into quotas of at least €1 each. There is no minimum capital requirement, but it must have a minimum of two quota holders. The transfer of quotas is subject to registration with the Commercial Registry. The SA is the second most popular legal format. It has a minimum capital of €50,000, at least 30 per cent of which must be paid upon incorporation. Capital is represented by freely transferable shares, which may be issued to the bearer. It has a stricter regulatory compliance, including a mandatory annual audit by a certified auditor (applicable to other business entities only where they exceed a certain size or have a regulated activity – e.g., financial).

Partnerships are less common. Registered partnerships may take on the format of a general partnership with unlimited liability of all members or a partly limited partnership that must have at least one unlimited partner (the general partner, who contributes goods or services and takes on the management) and one or more limited partners (who contribute capital and have no management responsibilities). Certain professions, such as lawyers, may adopt profession-specific forms of partnership.

The silent partnership, which is not subject to registration, is formed by a private agreement under which a general partner takes on the partnership management and has unlimited liability, and the limited partners contribute capital, are entitled to profits and, subject to the partnership agreement, may or may be liable for the business's losses.

Joint ventures generally take on the form of either a consortium, which may have limited liability subject to certain legal requirements, or of an economic interest grouping, which has unlimited liability.

A sole trader or independent professional may choose among one of three business entity formats: (1) the *unipessoal Lda*, which is essentially an Lda having a single quota holder; (2) the *estabelecimento individual de responsabilidade limitada*, which is a sole proprietorship in which the liability of the proprietor is limited to the assets allocated to the business; and (3) the sole trader or independent professional having unlimited liability.

Foreign companies carrying out business activities in Portugal directly may create a representative office (not subject to commercial registration) or register a local branch. Both are extensions of the represented business entity, without separate legal personality. Registration of a branch is mandatory where effective business activities are carried out in Portugal for a period in excess of one year. The management of the branch is performed under delegation of powers by the headquarters. It is, in practice, treated as a domestic company with regard to taxation and compliance, but unlike other jurisdictions, there is no requirement to file the 'parent' accounts in Portugal, and unlike a domestic company, the distribution of profits by the branch to the parent is not subject to any taxes. The foreign entity having a Portuguese branch is a popular structure for some types of investment, such as in real estate.

ii Corporate income tax

Corporate income tax (CIT) is levied on: (1) the worldwide profits realised by any business entity, incorporated or unincorporated, that is resident in Portugal for tax purposes; (2) profits attributable to the Portuguese permanent establishment of a non-resident entity; and (3) on Portuguese-source income obtained by a non-resident entity without a Portuguese permanent establishment.

Resident entities

As a rule, all business entities, incorporated or unincorporated, are treated as corporations for tax purposes. However, the following entities, despite being subject to CIT, are exempt from tax and their profits are attributed to its partners or participants:

a unincorporated civil partnerships;

b professional companies (i.e., companies that are held by professionals to carry out their professional activities);
c joint ventures under the form of domestic complementary groupings of enterprises and European economic interest groupings; and
d companies merely holding assets that are either controlled by a family group or owned by fewer than six shareholders.

In general, CIT is levied on the profits of business entities at a rate of 21 per cent. Most municipalities levy a surcharge of 1.5 per cent on the entity's profits, effectively increasing the tax rate to 22.5 per cent. Additionally, a solidarity surcharge of 3 per cent applies to profits ranging from €1.5 million to €7.5 million, 5 per cent on profits from €7.5 million to €35 million and 9 per cent on the excess profits.

Taxable profits consist of the entity's accounting profits adjusted under specific rules defined under the CIT Code (mostly related to timing and allowable deductions).

In general, all business expenses are deductible for tax purposes. Note, however, that net interest expenses are deductible only up to the higher of €1 million or 30 per cent of adjusted EBITDA. Any exceeding financing expenses of a given tax year may be deductible on the following five years, after deducting the financing expenses of each year, provided that the above-mentioned limits are not exceeded. Whenever net financing expenses do not exceed 30 per cent of earnings before depreciations, net financing expenses and taxes, the unused part increases the maximum deductible amount during the following five years.

Also, the CIT Code includes transfer pricing rules, which follow the general OECD guidelines. According to these rules, commercial transactions between associated enterprises should be subject to identical terms and conditions to those that would be accepted and agreed between independent entities (arm's-length principle). These provisions apply to dealings between a branch and its headquarters. There are several compliance obligations in relation to transactions between related parties that are applicable to any entity with income in excess of €3 million.

Tax losses may be carried forward within the following time limits: (1) tax losses generated from 1 January 2014 through 31 December 2016 can be carried forward for 12 years; (2) tax losses generated from 1 January 2017 onwards can be carried forward for a five-year period.

The deduction of tax losses carried forward is limited to 70 per cent of the taxable profit assessed in the relevant fiscal year. There is no rule regarding the identification of which losses are being carried forward, so it is possible to offset losses realised in later periods before exhausting the losses from previous periods.

Non-resident entities

Non-resident entities are taxable on their Portuguese-source income. These entities' income, where attributable to a permanent establishment, is subject to CIT under the same rules applicable to domestic entities. Portuguese-source income that is not attributable to a permanent establishment is normally subject to a final withholding tax and the non-resident entity is not under any compliance obligations. An exception to this rule applies to real property rental income and capital gains, which must be included in an income tax return to be filed with the Portuguese tax authorities by the non-resident entity.

The domestic withholding tax rate on Portuguese-source income realised by non-resident entities without a permanent establishment in Portugal is 25 per cent. Note, however, that most classes of income are exempt from tax under applicable double tax treaties. The notable exceptions are dividends, interest and royalties, which remain generally subject to a final withholding tax under the treaties (albeit at lower rates of typically 10 per cent or 15 per cent).

In addition, dividends distributed by a Portuguese company to its shareholders resident in the European Union (EU) or in the European Economic Area (EEA) are exempt from tax to the extent the shareholder holds a participation of at least 10 per cent for an uninterrupted period of at least one year. The tax withheld during the first year may be reimbursed upon completion of the minimum holding period. Dividends distributed to non-qualified shareholders are subject to the general withholding tax rules described above.

Furthermore, interest paid to EU or EEA entities that own at least 25 per cent of the share capital of the borrower (or the borrower and lender are held by the same entity in a percentage in excess of 25 per cent) is exempt from tax, to the extent the participation has been held for an uninterrupted period of at least two years. The tax withheld during the initial two years may be reimbursed upon completion of the minimum holding period.

Under Portuguese law, there is no withholding tax on the remittance of profits by a permanent establishment. Also, there is no additional or higher corporate income tax on the permanent establishment profits to compensate for the absence of this withholding tax.

iii Indirect taxes

The most relevant indirect taxes, from a transactional tax planning perspective, are stamp tax and real property transfer tax (IMT).

Stamp tax is charged, among other contracts, on loans and guarantees, at the rate of 0.5 per cent over the principal (the rate is 0.6 per cent where the maturity of the contract exceeds five years). According to its territoriality rules, this tax is levied only to the extent the relevant contracts are executed in Portugal. This principal is expanded under several rules, including the taxation of loans and guarantees[2] granted by non-resident entities to Portuguese resident entities, irrespective of where the contract is materially executed.

Several exemptions apply, of which the most relevant are (1) an exemption for intra-group loans (although subject to several requirements related to maturity and allocation of the funds), and (2) a general exemption for bond issuances. Most of the tax planning related to stamp tax involves these two exemptions.

IMT is charged on the transfer of real property located in Portugal. The tax is levied, at the rate of 6.5 per cent, on the higher of the property's tax registration value (all the properties in Portugal are registered with the tax authorities) or the consideration paid for the transfer.

The acquisition of a participation of more than 75 per cent of the share capital of an Lda is treated as a direct acquisition of this company's real estate for purposes of this tax. For this reason, most companies that hold real property in Portugal are incorporated as SAs. When that is not the case, a common strategy is to convert Lda into SA before the transfer of the shares. There is currently ongoing litigation with the tax authorities in relation to the transformation of these companies, on the grounds of abuse.

In addition, the transfer of properties in the context of tax neutral reorganisations (mergers, spin-off and contribution of businesses) is exempt from this tax. It is common to structure real property acquisitions through one of these transactions.

2 Security on taxed loans is not subject to tax, provided that the instrument only secures the loan obligations and the loan obligations are executed simultaneously to the execution of the loan.

III DEVELOPMENTS IN COMMON OWNERSHIP AND TRANSACTION STRUCTURES

i Real estate investment structures

Real estate investments (residential or commercial) are normally structured through a Portuguese SA (PropCo), to which the investors contribute equity and debt to fund the acquisition of the property, or a Portuguese real estate investment fund or company.

In the first alternative, rental income and capital gains realised by the PropCo are subject to Portuguese CIT. However, both depreciation and interest (within the 30 per cent of EBITDA or €1 million 'interest capping rules') are allowed as deductions from taxable income. On development projects of residential units, where interest accrues several years before the short period where income is produced, companies capitalise part of the interest expense (i.e., interest is added to the tax basis of the asset, rather than being considered a current expense). The capitalised interest is currently not subject to the interest-capping rules. Note, however, that according to draft legislation, this loophole will be closed shortly, meaning that capitalised interest will be subject to the capping rules (as such the tax basis of the assets will not be increased in the proportion of interest that exceeds the current limit).

The three main tax issues in these structures, from the investor's perspective, are: (1) stamp tax; (2) withholding taxes; and (3) capital gains. Loans are generally subject to stamp tax. This tax is levied at the rate of 0.5–0.6 per cent over the amount of the loan principal. As explained above, interest and dividends paid to non-resident investors are generally subject to withholding tax in Portugal. Capital gains realised on the transfer of shares in land-rich companies are also subject to tax in Portugal.

Considering these issues, it is common for non-resident investors to hold the shares in PropCo through a Luxembourg holding company. Typically, there is one PropCo for each real property investment. All the PropCos are directly held by the Luxembourg Holding Company. This company owns 100 per cent of the equity in PropCo and, in addition, funds it with shareholder loans. This structure minimises the tax implications for the investors, in particular, it allows for the payment of dividends and interest free of withholding tax; the shareholder loans are not subject to stamp duty (which is normally levied at); and capital gains on the future transfer of the shares (or upon liquidation of the PropCo) are not subject to tax in Portugal (under the Portugal–Luxembourg tax treaty).

Another tax-efficient alternative to provide loans is through an issue of listed bonds by the PropCo. These bonds are not subject to stamp tax and, under domestic rules, the interest is free from withholding tax to the extent it is paid to non-resident lenders.

The second investment alternative identified above is investing through real estate investment companies. These entities are incorporated as SAs but must be managed by a regulated asset manager. Although they are subject to corporate income tax, they benefit from a special exemption on specific categories of income, namely on investment income, rental income and capital gains. Therefore, only a small portion of its income is effectively taxed.

Dividends distributed by these entities to foreign investors benefit, in addition, from a lower 10 per cent withholding tax, rather than the general 25 per cent rate. The reduced rates do not apply to tax-resident investors or foreign investors that reside in a listed tax haven. Although no court or administration rulings were issued on this matter, we understand that these dividends should be exempt from tax if the beneficiary is a qualifying EU shareholder.

In January 2019, the Portuguese government enacted legislation that regulates Portuguese REITs. These entities will benefit from the same tax regime applicable to real estate investment companies (described above). The main differences are that, on the one hand, REITs are self-managed. On the other hand, their indebtedness capacity is limited to 60 per cent of the total assets value and they must distribute 75 per cent of the yearly real estate income and 90 per cent of securities income (from investments in real estate companies or investment funds). None of these features are imposed on real estate investment companies. Despite the regime being in force for over a year now, none of these entities has been set up to date.

The law foresees the possibility to convert commercial and real estate investment companies into a REIT. It is not clear, however, how the market will react to this new instrument, in particular because there is no significant tax benefits when compared to regular real estate companies.

Finally, a common structure to hold Portuguese real property by foreign investors is directly through a branch of an SPV incorporated abroad. The branch is subject to tax as a local company on its profits (rental income and capital gains), but gains realised on an indirect sale of the asset, by transferring the SPV shares, would not be subject to tax in Portugal. In January 2018 a new rule was inserted in the CIT Code that subjects to tax gains realised on the transfer of any non-resident entity where more than 50 per cent of its assets consist of real property located in Portugal.

This rule does not cover double-tier structures, whereby the shares of a holding company (rather than the real estate company) are transferred. Also, some of the Portuguese double tax treaties (most noticeably with Holland and Luxembourg) exempt these gains from tax.

ii Leveraged buyout

Leveraged buyout transactions are normally executed through the incorporation of a Portuguese acquisition vehicle (SPV) – an SA or Lda – that is funded with equity and debt (both intra-group and third-party loans). After the acquisition of the target company, the SPV is merged into the target in a reverse merger transaction, by virtue of which the shares of the acquired entity are attributed to the SPV shareholders. This allows the interest on the acquisition debt to be offset against the profits of the target company (within the limits of the interest-capping rules described above).

These transactions, however, are currently being challenged by the Portuguese tax authorities. In fact, the tax authorities have been issuing corporate income tax deficiencies related to the disallowance of interest deductions by the target on the loans originally extended to the SPV (for the acquisition), on the grounds that such interest is unrelated to the target's business. There are several cases under discussion in court. Recent decisions have been ruled in favour of the taxpayers, including a recent one from the Supreme Court. This, however, has not changed the interpretation of the tax authorities that have been consistently challenging the interest deduction in the tax audits.

The normal alternative to the reverse merger is applying for the tax consolidation regime, that if properly structured should allow for an effective interest deduction (within the interest-capping rules). Nevertheless, there is a timing inefficiency in this alternative, because the consolidation regime applies only if at the date of the beginning of the fiscal year the relevant corporate structure existed for a period longer than one year. For this reason, the deduction of interest on the initial two years could be lost.

Other tax-planning issues in these structures involve stamp tax and withholding taxes, particularly on third-party debt. Intra-group loans, as explained, are generally exempt from stamp tax and withholding taxes. Regarding third-party loans, it is common for the SPV to issue listed bonds (which are exempt from stamp tax and withholding tax, under certain conditions). Listed bonds may be held by a single bond-holder. In cases where the SPV is merged into the target, as a result of the merger, these bonds are automatically deemed to have been issued by the target.

iii Private equity

In the specific case of leveraged acquisitions of assets (either shares or debt) by international private equity funds, in addition to the issues described in the previous paragraphs, recent ruling from the Court of Justice of the European Union (CJEU)[3] has brought existing fund structures under pressure, in particular concerning the withholding tax exemption on intra-group loans's interest payments (under the Interest and Royalty Directive 2003/49/EC (IRD)) and dividend distributions (under Parent–Subsidiary Directive 90/435/EEC (PSD)).

The CJEU ruling, apart from reaffirming the general principle of prohibition of abuse under EU law, has expanded on the concept of beneficial owner. The CJEU held that to qualify as beneficial owner of dividends and interest, the recipient must economically benefit from and retain the power to determine the use of the income. The CJEU also stated that the amendments to OECD Model Tax Conventions and related commentaries occurred after the adoption of the directives must be taken into account.

Specifically with reference to the PSD, the CJEU stated that its benefit must be denied if the beneficial owner of the dividends is an entity resident in a non-EU jurisdiction. This conclusion applies regardless of the existence of an abusive practice.

The CJEU furthermore held that the requirement of 'being subject to corporate income tax without being exempt' cannot be considered as being met by a company that, although being liable to corporate income tax in its state of establishment, is effectively not subject to this tax on the interest received. Accordingly, the CJEU found that if the domestic court were to confirm that a Luxembourg company authorised to operate as SICAR benefits from an exemption that specifically applies to interest income, the company does not qualify for the application of the IRD.

Most acquisitions of Portuguese companies and corporate debt by international private equity funds are structured through companies domiciled in Luxembourg, often formed as SICAR. The Luxembourg entities are directly or indirectly owned by funds located outside the EU. In some cases, the Luxembourg entities have sub-participation agreements to adjust the corporate structure to the investment policies of several funds.

It is possible that, in some specific cases where the Luxembourg entities are not the beneficial owner of the income, the Portuguese tax authorities challenge the dividends and the interest withholding tax exemptions under these directives, on the same grounds as the CJEU.

3 In particular, judgments in joined cases C-115/16, C-118/16, C-119/16 and C-299/16 and in joined cases C-116/16 and C-117/16, respectively concerning the Interest and Royalty Directive (Directive 2003/49/EC (IRD)) and the Parent Subsidiary Directive (Directive 90/435/EEC as applicable at the time of the cases (PSD, and together with IRD, 'the Directives')).

iv Debt restructuring

Debt-for-equity swap transactions are currently very common in Portugal, with special emphasis on the concessions and private–public partnerships. These transactions typically involve the acquisition of the debt, at discount, by international funds (through Luxembourg companies) from Portuguese lenders (mostly banks). Typically, the investor converts part of the debt into equity (to gain control of the company) and also agrees on a substantial haircut.

Apart from the withholding tax issues discussed above, the main tax issue in these transactions is related to debt cancellation income, particularly because the Portuguese tax authorities' position is that debt cancellation, even by the shareholders, consists of taxable income of the debtor.

The tax-planning alternative has been to file for a simplified out-of-court Chapter 11 restructuring. This has attached several tax benefits, including the exemption of any cancellation of debt income.

Two other planning issues in these transactions are avoiding the expiration of tax losses and the special interest withholding tax exemption for concessionaire entities. Regarding the first, note that, as a rule, tax losses expire upon the transfer of more than 50 per cent of the share capital. In relation to the second, note that debt holders on concessionaries and PPPs, upon request, may benefit from a withholding tax exemption. This exemption expires with the assignment of the debt. In both cases, it is possible to request an authorisation with the tax authorities to avoid the expiration, based on valid economic reasons for the transfer.

IV OUTLOOK AND CONCLUSIONS

It is expected that the current pandemic will have an enormous negative impact in the Portuguese economy, in particular because it is highly dependent on the real estate market and all economic activities related to tourism, two of the industries that are expected to be among the most hard hit in the coming months or even years.

This situation will most likely cause a substantial number of existing companies going into restructuring or bankruptcy. It is expected that most of the tax planning in the next quarters will be focusing around these areas, which have very specific taxation rules on the taxation of losses, debt write-off and distressed sale of assets.

It is also likely that, from the third quarter onwards, international investors, in particular private equity funds, will acquire struggling businesses through debt-equity swaps. Tax planning will revolve around the same issues that were discussed in this chapter, in particular, issues around the deduction of interest and cancellation of debt income.

Also, it is likely that the recent decisions by the CJEU will lead to litigation in relation to the interest and dividends withholding tax exemption under the IRD and the PSD, in particular, in transactions where the investors are Luxembourg entities incorporated by private equity funds.

We expect that real estate developers will struggle with the sudden drop of the number of transactions. This will probably lead to distressed sales. Tax planning issues will be mostly related to the efficient acquisition structures and IMT planning. A great deal of tax litigation is expected by Portuguese investment funds, particularly owing to the tax authorities' interpretation that gains realised on development projects are not covered by the general investment funds exemption.

Finally, it is likely that two cases will be brought to court in relation to investment funds. The first relates to the taxation of gains on development projects. The tax administration's interpretation has been that these gains are not included in the general investment funds income tax exemption. The second is the withholding tax exemption on interest and dividends paid by real estate investment companies to its non-resident shareholders (bondholders).

Appendix 1

ABOUT THE AUTHORS

ANTÓNIO ROCHA MENDES

Campos Ferreira, Sá Carneiro – CS Associados

António Rocha Mendes is a partner and heads the tax department at CS Associados. With more than two decades of experience, he provides local and cross-border tax advice to private equity houses, infrastructure funds, credit and financial institutions and multinational corporations, mostly in the areas of corporate income tax. António Rocha Mendes graduated in law in 1993 at the Catholic University of Portugal and holds an LLM from Boston University School of Law (1999).

CAMPOS FERREIRA, SÁ CARNEIRO – CS ASSOCIADOS

Avenida da Liberdade, 249, 8°
1250-143 Lisbon
Portugal
Tel: +351 211 926 835
Fax: +351 211 926 899
antonio.rochamendes@csassociados.pt
www.csassociados.pt

an LBR business

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