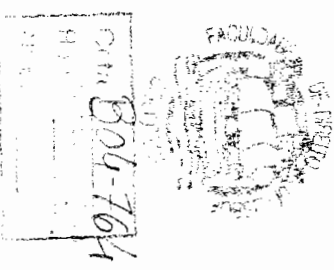


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Bertil Winman (ed.)

TAXATION OF SMALL
AND MEDIUM SIZED ENTERPRISES

National Reports presented at the Stockholm School
of Economics June 10-12, 1999



24. Conclusions

As I have already said in the introduction, the actual Italian tax regime for small and medium enterprises must not be evaluated only according to the domestic tax policy goals, but also in the context of the European Union, since this is *de facto* required by the introduction of the single currency⁷⁴.

The recent statement (9 December 1996) by the EU Council of Ministers proves that this segment of production, representing Italy's main business axe, is also particularly relevant for the EU economy, despite being SMEs mostly lacking at an own international dimension.

In my opinion three main issues arises at the EU level.

Despite relevance of SMEs for community law, no whatsoever form of harmonisation exists at the present with respect to direct taxes, wich most directly have an impact on small enterprises.

Secondly, no guidelines for a common tax policy have been adopted so far on SMEs.

Thirdly, clarity is required with respect to the basic dicotomy between general EU tax policy, aimed at securing neutrality and SMEs EU tax policy, which should instead be oriented towards non neutrality.

Recent innovations in the Italian tax system, i.e. Dual Income Tax and IRAP – Local Tax on Productive Activities, comply with the above EU position. Tax measures stimulate eterprises at keeping balance in their financial situation and equity rather than debt. Despite little formal requirements for SMEs, some more transparent access to their economic situation should be granted in order to permit a further reduction in the tax burden with respect to this situations.

I would also positively consider the introduction of new incentives in this context, aimed at stimulating new business, as well as of common harmonized standards for administrative and accounting requirements concerning all SMEs in the European Union.

TAXATION OF SMALL AND MEDIUM-SIZED ENTERPRISES

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National Report: PORTUGAL

⁷⁴ CONF/APP – CER, La moneta unica e le piccole e medie industrie, Turin, 1998.

**I. DEFINITION OF MICRO AND SMALL ENTERPRISES IN
FINANCIAL INCENTIVE AND TAX INCENTIVE LAWS..... 174**

**II. BASIC STRUCTURE OF TAXATION FOR SMALL AND MEDIUM-
SIZED ENTERPRISES..... 177**

1. TAX BENEFITS REGIME APPLICABLE TO MICRO AND SMALL ENTERPRISES 177

2. INCOME TAX REGIME 178

2.1. *Taxation of sole ownership*..... 179

2.1.1. Taxation of residents..... 179

2.1.2. Taxation of non-residents: income earned in Portuguese territory... 183

2.1.3. Basis of assessment for resident taxpayers and non-resident individuals
with a permanent establishment in Portugal 184

2.1.4. Resident taxpayers' personal allowances 186

2.1.5. Accounting and other obligations..... 186

2.1.6. Indirect assessment of small enterprises according to the General Tax
Law 187

2.1.7. Tax rates 189

2.2. *Taxation of corporations*..... 190

2.2.1. Taxpayers 190

2.2.2. Tax base 191

2.2.3. Tax rates 192

2.3. *Partnerships*..... 193

2.4. *Double economic taxation of corporations and partners*..... 194

III. TRANSFER AND LIQUIDATION OF BUSINESSES..... 194

1. TRANSFER OF INDIVIDUAL BUSINESSES..... 194

2. TRANSFER OF SHARES AND LIQUIDATION OF THE COMPANY 194

IV. CHANGE OF LEGAL STATUS 195

V. ANTI-ABUSE MEASURES 196

Introduction

The Portuguese tax regime applicable to small and medium-sized companies is, as a rule, the general regime of income tax codes. This is applied to enterprises' income, either as corporate income tax or personal income tax, depending on the juridical form of those enterprises. As mentioned below, Portuguese tax law has only a partial acceptance of the distinction between partnerships and stock corporations. Thus as a rule, only individuals are subject to the personal income tax whereas corporations and other entities other than individuals are subject to the corporate income tax. Furthermore the gap between effective rates of corporation tax and the top bracket of the personal income tax has been small and therefore beyond a certain level of profits there is tax neutrality between the different legal forms. The tax regime of reinvested profits by sole proprietorships and partnerships does not particularly distort competition between enterprises¹.

The income tax codes (Corporate Income Tax Code and Personal Income Tax Code, hereafter CITC and PITC) neither create any special tax regimes for these types of enterprises nor contain any definition of small and medium-sized enterprises.

I. Definition of micro and small enterprises in financial incentive and tax incentive laws

However, some Portuguese laws contain the definition of micro and small-sized enterprises. Examination of this definition in laws on financial incentives or tax benefits revealed the following:

Since the mid-nineties, there have been some financial incentives (such as direct subsidies) and tax benefits attributed to micro and small-sized enterprises.

The laws and decree-laws governing this regime are frequently connected to the implementation of EU funds and the creation of employment. Lately, these financial or tax incentives have been attributed to the poorest regions of the country. The incentives for micro and small companies include tax exemptions for the purchase of an apartment as the permanent residence for workers within the region that benefits from the tax incentives regime, or the purchase of a "immovable property or autonomous portion thereof" used in the enterprise's activity.

These laws cover an average period of three years, but the same kind of tax incentives have been periodically renewed.

Ruling n. 154/96 from 17th of September (applying Decree-Law 34/95, 11 February), established the regime of financial incentives to micro and small enterprises, including a different definition of both types of enterprises. According to article 4 n. 1, micro-enterprises must have a maximum of nine workers, independently of the juridical form of the enterprise. According to n. 2 a), small enterprises have more than nine and less than fifty workers. Institutions with non-profit-making aims and individuals can also apply for this financial incentive regime. Besides being a micro or small enterprise, the productive investment project must not exceed the fixed capital of 100, 000 Euros, unless it was connected to social welfare or the environment.

Decree-law n. 200/96 (18 October) extending the regime of previous legislation (Decree-law n. 121/95, 31 May) gave a tax credit to "relevant investment" which applied to all types of enterprises, provided they were resident in Portugal or non-resident but with a permanent establishment in Portugal. Furthermore, D-L n. 200/96 attributed a special tax credit in case of investment by micro and small enterprises. Article 3 of Decree-law n. 200/96 defined micro and small enterprises as those that, in 1996, had over 3 but under 20 workers and a turnover of no more than 2,500,000 Euros.

Decree-law n. 42/98 (3 May) defines small enterprises as those that do not exceed 3,000,000 Euros of turnover in the first year that they benefit from the tax incentive – which has the form of a tax credit.

The budget for 1999 also contains tax incentives for micro-enterprises and for the interior regions of the country. A micro-enterprise may not be a joint stock company (S.A.) and its turnover may not exceed 150, 000 Euros.

¹ See Commission Recommendation 94/390/EC of 25 May 1994, Official Journal no. L 177/1, 9 July, 1994.

	Decree-law 200/96, 18.10	Ruling 154/96, 17.9	Decree-law 42/98, 3.5	Budget law to 1999, 31.12
Micro and Small-sized Enterprises	Number of workers >3 < 20	Number of workers Micro: <9 Small-sized: <50	Number of workers	Number of workers
Micro and Small-sized enterprises	Volume of business Not more than 2.500,000 Euros	Amount of fixed capital Not more than 100, 000 Euros	Volume of business (small enterprises) Not more than 3, 000, 000 Euros	Volume of business (micro enterprises) Not more than 50, 000 Euros

There is a remarkable difference between the volume of business of micro and small enterprises, as we may verify. It should be stressed that micro enterprises still have an important role in the Portuguese economy.

We may consider these definitions broadly correspond to the definitions recommended by the European Commission in April 1996 (96/280/EC, Official journal no. L 107, 30/04/96), especially when the Commission recognises the necessity of distinguishing among micro, small and medium-sized enterprises. In Portugal, medium-sized enterprises are not object of the aforementioned tax benefits.

II. Basic structure of taxation for small and medium-sized enterprises

1. Tax benefits regime applicable to micro and small enterprises

All the mentioned laws have some aspects in common:

- They apply to a broad range of activities: industrial, commercial and even agricultural, although only to what is called and defined by law as "relevant additional investment";
- "relevant investment" was defined in 1995 as the investment in "tangible fixed assets" for use by the enterprise in Portuguese territory. Some exceptions were made for goods not directly or necessarily related to the enterprise's activity;
- there must be an increase in investment and sometimes of taxable profits, in comparison to the previous tax years;
- they apply to both resident enterprises and non-residents with a permanent establishment in Portuguese territory;
- the income tax incentives are only attributed either through a tax credit in corporate income tax or through a combined tax credit and reduction in the tax rate of corporate income tax;
- in fact, personal income tax incentives are technically very difficult to attribute, as they would have to be calculated according to the commercial income category, and then subject to globalisation and progressive taxation;
- there is also normally exemption from stamp duties when equity capital is increased;
- when the enterprise is owned by young entrepreneurs, the regime is still more beneficial;
- profit retention entitles enterprises to a higher tax credit for the following year of the tax incentive regime;
- there is some concern about tax avoidance. Therefore, there are specific clauses for this purpose;
- these small companies may not, directly or indirectly, be over 50% owned by a non-small company; they also cannot be the result of a demerger carried out after the publication of the tax incentive-law;

- tax profits must be determined by the so-called "direct method";
- they must, by law, have organised accounting;
- the goods that are the subject of the investment must be kept in the company for a minimum period of time;
- they may not be in debt to the state, the social security or workers;
- mergers and similar operations are not incompatible with the tax incentive regime, provided all the other conditions are adhered to;
- the company accounting must show the tax incentives that it benefited from;
- there can be no accumulation of similar tax incentives.

In the most recent years tax benefits were object of re-evaluation and may in the near future be object of reform. Although in the end of the eighties a rather coherent system of tax benefits was introduced by the Tax Benefits Code, since then ad hoc legislation attributing tax benefits has often been approved - tax benefits to micro and small-sized enterprises being an example. The recent re-evaluation of the tax benefits has demonstrated their discriminatory and distortion effects and some lack of co-ordination and political orientation in their concession.² The recent General Tax Law (Decree-Law n. 398/98, 17 December) - hereafter GTL - dedicates an article to tax benefits, establishing for example that in principle rules attributing tax benefits are in effect during a period of five years and the creation of tax benefits depends on the previous quantification of the tax expenditure (article 14 n. 1 and 3 GTL).

2. Income tax regime

The different forms of a small or medium-sized enterprise are basically sole ownership and corporations. In addition, under certain circumstances, partnerships have a special tax treatment.

2.1. Taxation of sole ownership

2.1.1. Taxation of residents

a) General remarks

We will start with taxation of sole ownership.

As regards resident taxpayers, and as imposed by article 104 no. 1 of the Constitution Portuguese personal income tax takes into account global income and subjects it to progressive rates. However until the deduction of personal allowances, it uses the technique of isolating categories of income.³ The law defines nine different categories of income: income from dependent work, income from independent work, commercial and industrial income, agricultural income, capital income, real estate income, capital gains income, income from funds and other income.

In the first place, this technique aims to determine the taxable items of income, but, as happens in other countries that adopt the same system, it may in practice be difficult to include the income in a specific category.

Furthermore, the different categories of income are integrated into a partially analytical system in order to determine net income. In fact, in contrast to a synthetic system, each income category is subject to specific deductions. Expenses are not transferable among categories. This solution was designed as an anti-abuse measure, but the analytical system is not absolute: losses obtained in some categories are deductible from the whole of the taxable net income, introducing an element of communication among categories, and a more equitable solution.

However, losses incurred in independent work, commercial, industrial, agricultural and real estate income and capital gains, cannot be transferred to other categories in order to avoid big losses of tax revenue, but simply deducted within the same category. As regards capital gains, when subject to taxation they are withheld at source, but the taxpayer may opt to include them in the global income. In this case, capital losses are only deductible from capital gains in the two following years. Deductions for the other mentioned items of income in which losses are not transferred may occur in the subsequent five years.

² Reavaliação dos benefícios fiscais, Relatório do Grupo de Trabalho constituído pelo despacho n. 130/97-XIII do Ministro das Finanças, in *Cadernos de Ciência e Técnica Fiscal* n. 180, Lisboa, 1998, M.H. FREITAS PEREIRA, Os Incentivos fiscais e o financiamento do investimento privado, in *Influência da fiscalidade na forma de financiamento das empresas*, Lisboa, Centro de Estudos Fiscais, 1980.

³ Considerations about this method are made by SOARES MARTINEZ, *Direito fiscal*, Coimbra, 1993, 553 ff., and MÁRIO ALEXANDRE, *A Reforma do sistema de tributação do rendimento das pessoas singulares em Portugal*, in *Ciência e Técnica Fiscal* n. 361, 1991, 119 ff.

As mentioned below, non-residents' gross income is subject to final withholding rates, unless there is a permanent establishment situated in Portugal for commercial, industrial or agricultural activity.

Thus, sole ownership of a small or medium-sized company may be taxed under three different categories: income of independent workers (category B), commercial or industrial income (category C), or agricultural income (category D) (articles 4 and 5 of the PITC), depending on the activity.

b) Independent workers' income

The Personal Income Tax Code considers independent workers' income (article 3 PITC) as:

- income resulting from a scientific, artistic or technical activity, listed in the appendix;
- income from intellectual or industrial property and the supply of information on experience acquired in the industrial, commercial or scientific sector, when given by the original owner;
- income from services that are not taxed under other categories, provided the taxpayer does not have any employee or co-worker;
- income from isolated acts of a scientific, artistic or technical character or rendering services.

As can be seen, some activities are taxed as independent workers' income and the individual people exercising these activities, constitute an enterprise. Therefore, some costs connected to the activity may be deducted within the limits established by law (article 26 PITC).

c) Commercial and industrial income

Commercial and industrial income corresponds to the profits resulting from these activities, some of which are listed in article 4 PITC, provided they are earned by physical persons.

In fact, as will be seen, some companies are taxed directly in the person of their partners, but this taxation follows the rules of the Corporate Income Tax Code.

1. Some of the cases exemplified by law (article 4 ns. 1 and 2 PITC) have been criticised for not corresponding either to commercial or industrial activities.⁴ Cases include income from advertising, management of goods, private security activities, information about commerce, brokerage, pro-

motion of customs orders, industrial property registers, compensation from the suspension or reduction of activities and income from independent activities not taxed under other categories. Some of these cases were taxed under the Professional Income Tax Code⁵ before the 1988 tax reform, which introduced the present PITC and CITC. However, as said, the Personal Income Tax Code did not include them in category B (i.e. income of independent activities), which would have been more rigorous.

2. The other examples contained in article 4 n. 1 do not raise any problems, as they undoubtedly correspond to this item of income.

3. Besides this relatively problematic definition, income from other categories, whenever accessory to, connected to, or integrated within an industrial or commercial activity taxed in Portuguese territory, is also included in this category (article 4 n. 2 from a) to e) PITC). The following are some examples:

- capital gains resulting from commercial or industrial activities, when arising from the onerous transfer of real property affected to the assets of the enterprise, to the private property of the entrepreneur (d));
- agricultural income when exploitation of land is clearly accessory to or when agricultural activity is integrated into commercial or industrial activities (a) and b));
- capital income and real estate income when connected to commercial or industrial activities (c)).

The criteria of agricultural activity being accessory to or integrated into a commercial or industrial one is defined by law⁶. If the agricultural activity is not integrated in the commercial or industrial activity but co-exists with it,

⁵ Indemnities from the suspension or reduction of activities were taxed as capital income (under the Capital Tax Code) before the 1988 tax reform. The current regime is justified by the connection of this income to commercial or industrial income.

⁶ Exploitation of land is considered clearly accessory when its direct costs are inferior to 25% of global direct costs of the total activity (article 4 n. 3 PITC). Agriculture, forestry and cattle-raising are considered to be integrated in commercial or industrial activities when more than 60% of the value of their products are destined for use or consumption in those activities (article 4 n. 4 PITC). In the latter situation, the *ratio legis* is that integrating agriculture, forestry and cattle-raising activities into commercial or industrial ones means greater ability-to-pay. Therefore, all activity is taxed under category C: PINTO FERNANDES and CARDOSO DOS SANTOS, *Código do imposto sobre o rendimento das pessoas singulares*, anotado e comentado, Lisboa, 1990, 122.

⁴ SOARES MARTINEZ, *Direito fiscal*, cit., 561-562.

taxation is calculated separately according to categories B and C, and the accounting must separately reflect the results of each activity.

Capital income connected with commercial or industrial activities is taxed under this category, in order to avoid double taxation, as they would in any case be included in taxable profit of commercial or industrial activity. However, interest from bank deposits and from bearer bonds are withheld at liberty rates according to article 74 a) and b) of the PTTC.

Furthermore, income which would in principle be taxed under the corresponding categories, but was not included in the legislation - that is, the regime applied to the income of independent workers and of derived financial instruments, when not included in their respective categories (article 4 n. 2 f) and g)) - is residually taxed under commercial and industrial income. However, in the rule defining independent income, legislation uses the same technique, which raises problems of interpretation. Article 3 covers income from independent activities (category B), and its n. 4 states that income earned within the independent exercise of rendering services not included in other categories is taxed under this category B, provided the taxpayer does not have any employee or co-worker in his service.

These "subsidiarity clauses", which are also commonly used in other tax laws - internal and foreign - need to be clearly written.

Thus, the question is whether those activities taxed under Professional Income Tax Code and others not covered by category B of PTTC should be taxed as commercial or industrial activities.

The only possible interpretation seems to be the following: if the conditions under article 3 n. 4 are fulfilled (independent rendering of services provided the taxpayer does not have any employee or co-worker in his service), the taxpayer shall be taxed under it; otherwise, he will be taxed under category C.

Finally, isolated acts of commercial or industrial nature, not taxed under any other category, are also taxed under category C (article 4 n. 2 h)).

It is obvious that the legislation wanted to tax certain activities that do not exactly correspond to commercial, industrial or any other existing category without creating new categories.

This summarised description may lead to the conclusion that commercial and industrial income category is quite broadly defined and has some kind of attractive force for other items of income. In this sense, it may be added that the capital gains category is defined through a "subsidiarity clause", regarding commercial or industrial income as well as agricultural income and capital income (article 10 PTTC).

The law does not state whether commercial and industrial income requires that the activity is orientated to making profits. Internal administrative rules

have denied this subjective-voluntary element, considering for example that a physical person who owns a periodical publication of a scientific character with no aim of making profits is taxed under article 4 PTTC 7.

Thus the tax law definition of the "commercial or industrial nature of the activity" is understood as only referring to objective aspects of the activity.

d) *Agricultural income*

The profits from agriculture, forestry or cattle-raising activities are considered under agricultural income (category D). The autonomy of this category before this sector, even though some rules of commercial and industrial income category are applied.

As a rule, the examples given by law for income from agriculture, forestry or cattle raising (article 5 PTTC), correspond to income resulting from or connected to exploitation of the land. Thus, when exploitation of the land prevails over other activities that are accessory to that exploitation, income is taxed under category D. Besides, rendering services such as independent activities and leasing of equipment for use in agriculture, forestry or cattle-raising activities are also taxed under this category.

The accessory character also justifies taxation under this category D, of capital income, real property income, capital gains and sums given to private entrepreneurs to suspend or reduce activity when they are connected with agriculture, forestry or cattle-raising.

2.1.2. **Taxation of non-residents: income earned in Portuguese territory**

Income of non-resident independent workers is earned in Portugal when exercised in Portuguese territory (article 17 n. 1 a) PTTC).

Income taxed under this category (category B), when relating to intellectual or industrial property or royalties is considered to be earned in Portugal when the debtor is either resident or has a permanent establishment in Portugal (article 17 n. 1 d) PTTC).

In the case of income earned by non-residents taxed under category B, the Personal Income Tax Code makes no reference to taxation of permanent establishments.

Thus, non-residents are taxed at final withholding rates, even if they have a fixed place of business in Portuguese territory, unless there is a double taxation convention. In this case (if the non-resident independent worker has a fixed place of business in Portugal and if there is a double taxation conven-

⁷ Administrative internal rule de 31/1/89 de SBGD, information n. 208/89.

tion), he will be taxed under category B, according to the rules applicable to resident taxpayers.

Commercial, industrial or agricultural income is considered to be obtained in Portugal if it is attributable to a permanent establishment located in Portuguese territory (article 17 n. 1 e) PIRC).

Permanent establishment is here defined as any fixed place of business or permanent representation through which a commercial, industrial or agricultural activity is exercised (n. 2). This definition must be completed with the more detailed definition of permanent establishment given in the Corporate Income Tax Code (according to article 17 n. 3 PIRC), and with the necessary adaptations, as we are dealing with an individual's permanent establishment.

The following are also considered to be earned in Portugal even though the connection element - or the "economic allegiance"⁸ - seems not satisfactory according to the principles of International Tax Law⁹:

- income from acting as an intermediary in negotiating contracts when they involve a commercial, industrial or agricultural activity;
- income from other services performed or used in Portuguese territory, with the exception for transportation, communications and financial activities, when the debtor is resident in Portugal or the payment is made by a permanent establishment situated in Portugal.

2.1.3. Basis of assessment for resident taxpayers and non-resident individuals with a permanent establishment in Portugal

a) Determining net income of resident independent workers

Residents are taxed on their net income under category B, which is in principle determined according to real income. This is either based on the organised accounts when so required by law, or on the record books (article 27 PIRC).

In the cases determined by the General Tax Law (which are related with the impossibility of checking and of an accurate quantification of income), taxable income is based on the "indirect methods" (article 28 PIRC).

When there is a double taxation convention, these rules are also applicable to non-residents with a fixed base of business in Portugal.

b) Determining net income of commercial, industrial and agricultural activities

Residents earning income under category C are taxed according to their net income.

When income under categories C and D is earned in Portugal through a permanent establishment, non-residents are also taxed on their net income.

Thus, in determining the basis of assessment for resident individuals, the Personal Income Tax Code makes a general remittance to the Corporate Income Tax Code, but simultaneously establishes 8 articles (articles 32-39) with special rules applicable to commercial, industrial and agricultural income obtained by individuals:

1. The determination of taxable profit shall be made by self-assessment according to organised accounting (when the taxpayer must have one), or according to the record books when organised accounting is not compulsory. As a rule, and due to the remittance to the Corporate Income Tax Code, the taxable profit is based on real income.
2. Another of these special rules is a consequence of the aforementioned analytical system, as it only considers profits and costs related to the activity of the taxpayer's individual enterprise or to its assets. In fact, as will be shown, if the Corporate Income Tax Code regulations were here applicable, global income, wherever its origin or nature, would be taxed as profit.
3. Another special rule establishes that only essential and proven expenses may be deducted from isolated commercial or industrial acts: the expenses carried out to obtain income. In fact, these acts, being isolated, do not correspond to the exercise of a commercial or industrial activity. Furthermore, these individuals have no obligation to declare the start and cessation of an activity, to keep organised accounting and bookkeeping.
4. Deduction of losses is only possible in the case of succession by death of the taxpayer that incurred the losses.

⁸ KLAUS VOGEL, Worldwide vs. source taxation of income - A review and re-evaluation of arguments, Intertax, 1988, n. 8-9, 218 ff.

⁹ A severe critic to the connection elements established in article 17 of the Personal Income Tax Code is made by ALBERTO XAVIER, Direito tributário internacional, Coimbra, 1993, 256-259. The author criticises the adoption of several connections (debtor, paying agent, etc) and the resulting incoherent regime.

5. Taxable profit is, in exceptional cases, determined according to "indirect methods", using the Corporate Income Tax Code.

Besides the aforementioned articles, the following other rules are exclusively dedicated to the basis of assessment of agricultural income:

In multi-year exploitation of forestry, the part corresponding to the percentage that the exploitation represents of overall production is considered as costs.

In determining the basis of assessment of agricultural activities, the price of sale deducted from the margin of normal profit may always be considered. If the normal profit margin is not easily determined, it may be substituted by a deduction not superior to 20% of the sale price. This method is in general accepted in those sectors of activity in which the cost of acquisition or production is very expensive or cannot be accurately calculated.

Single lump-sum payment of grants for agriculture, forestry and cattle raising to abandon the respective activity, may be taxed provided they exceed costs and losses.

2.1.4. Resident taxpayers' personal allowances

Personal allowances are accepted only for residents. They are deducted from the total net income obtained as described above.

2.1.5. Accounting and other obligations

The start of independent workers activity, as well as of commercial, industrial and agricultural activity must be declared to the tax authorities (article 105 PTC). Cessation of activity must also be declared (article 106 PTC). Under category C, cessation occurs when the corresponding acts cease being practised on a regular basis, provided there are no fixed assets attached to the exercise of activity; when winding-up of stocks occurs, and equipment belonging to the owner of the establishment is sold; when the right to use and usufruct of the fixed assets attached to the exercise finishes and when ownership or exploitation of the establishment is transferred.

Independent workers' activities and commercial, industrial and agricultural activities must, in some cases, have organised accounting, namely: for category B taxpayers, when the average net income of the last three years is 20 times above the national minimum wage; categories C and D taxpayers have the same obligation when the average turnover during the last 3 years is over 150,000 Euros (article 109 n. 1 d) PTC).

This means that some small enterprises are not obliged to meet these obligations.

Taxpayers whose average net income or average turnover do not exceed the mentioned values are obliged to keep some registration books, as must VAT taxpayers if they exercise a commercial or industrial activity (articles 107, 108 and 111 PTC).

Agricultural income requires special books (article 112 PTC).

Only taxpayers with accounting obligations are obliged, for certain payments and other connected obligations, to fulfil the obligation to withhold the corresponding tax at source.

2.1.6. Indirect assessment of small enterprises according to the General Tax Law

Taxation of small companies' real income still has a short history in Portugal and is further complicated by bank secrecy.

In order to reduce tax avoidance by small enterprises, although CTTC accepts the balance sheet as the basis for profit calculation, it contains several restrictions on making provisions and depreciation.

The many cases of tax avoidance explain why the recent General Tax Law contains a number of rules concerning taxation of small enterprises according to the rules of "taxation a forfait".

The so-called indirect assessment may occur if (article 87 GTL):

- there is a simplified tax regime;
- there is no possibility of confirming the elements provided by the taxpayer;
- the taxable income is substantially lower, without justification, than the objective indicators of the activity.

The referred method will be applied if the record book obligations were not fulfilled (article 88 GTL).

The taxpayer may present justifications for the taxable income being substantially lower than the objective indicators of the activity, which are defined yearly by the Finance Minister after consultation with associations of enterprises and professionals (article 89 n. 2 GTL).

Thus, determining taxable income by indirect methods may take the following elements into account (article 90 GTL):

- the average margins of net profit over sales and services;
- the average rates of profitability for invested capital;

- the *ratio* of consumption of raw materials and other direct costs;
- the elements provided to the tax authorities;
- the place and size of the activity exercised;
- the presumed costs;
- the previous taxable income determined by the tax authorities.

This method means returning to the techniques of taxing "normal profit", as existed before the 1988 tax reform.

2.1.7. Tax rates

Residents' income is taxed at progressive rates:

<i>Taxable income</i> <i>>6,450,000 PTE</i>	<i>Normal rates:</i> <i>40%</i>	<i>Average rates</i>
Until 700,000 PTE	14%	14%
>700,000-1,105,000 PTE	15%	14,3665%
>1,105,000-2,750,000 PTE	25%	20,7273%
>2,750,000-6,450,000 PTE	35%	28,8720%

Married couples are subject to a joint regime, as required in the constitution, and must present a single declaration. The income is taxed according to a splitting system.

Most income earned by non-residents is withheld at source at a proportional tax rate. That is what happens with the income of independent workers (25%) and the profits obtained by non-resident shareholders paid by entities subject to corporate income tax (also 25%).

Category B income from intellectual and industrial property, as well as royalties received by non-residents is subject to a tax rate of 15% (article 74 n. 4 c) PITC).

However, the regime is different when there is a permanent establishment:

- non-residents' category B income may only be attributed to a permanent establishment if there is a double taxation convention. In this case, non-residents are taxed on net income, according to the rules of CITC, at the progressive rates of PITC applicable to residents;
- taxation of non-residents' income from commercial, industrial and agricultural activities is payable on net income, if attached to a permanent establishment. Likewise, in this case, the taxable profit is determined ac-

ording to the rules of CITC, but is subject to the progressive tax rates of PITC.

Commission payments for acting as intermediaries in contracts and income from other services rendered, as listed in article 17 n. 1 e) PITC, paid to non-residents are withheld at source at the final rate of 15% (article 74 n. 4 a) PITC).

Other category C income earned by non-residents is not taxed.

Final withholding rates applicable to non-residents

Independent workers	Intellectual and industrial property and royalties	Dividends obtained by non-resident shareholders	Dividends distributed by limited liability companies (<i>Sociedades por Quotas</i>)	Commission payments for acting as intermediaries
25%	15%	25%	20%	15%

It is difficult to justify the different tax rates, and they have been much criticised for being irrational and arbitrary¹⁰.

2.2. Taxation of corporations

2.2.1. Taxpayers

Corporations are taxed under the Corporate Income Tax Code, independently of size. Taxpayers under this code are all private or public corporate bodies, a further distinction being made between residents and non-residents (article 2 n. 1 a) and c) CITC).

Non-residents are taxed whether they have a permanent establishment or not (article 3 n. 1 c) and d) and article 4 n. 3 CITC) 1), contrary to the guidelines established by OECD.

Bodies that are not corporate entities, such as unincorporated companies, pay corporate income tax, a decisive feature being their ability-to-pay.

Co-operatives also pay corporate income tax, but agricultural co-operatives or those involved in agricultural activities, as well as housing and building co-operatives and teaching co-operatives are exempt.

Manufacturing and handicraft co-operatives are also exempt provided ¾ of their employees are partners, none owns more than 10% of the cooperative's stock capital, and the turnover does not exceed, in that period, 150,000 Euros.

Under the rules of the CITC, these co-operatives' withheld income, is not covered by the exemption.

2.2.2. Tax base

Every resident entity, considered as taxpayer under CITC and whose main activity is commercial, industrial or agricultural activity, is taxed for its profit. Profit is here defined as the difference between the value of net assets at the end of the tax period and its beginning (article 3 n. 1 a) and n. 2 CITC).

Taxable profit corresponds to the concept of accrued-income, and thus also to real income, as required by the Portuguese constitution. Therefore, companies have accounting obligations, which must be organised according to the law and the principle of clearness (article 17 CITC).

Losses are deductible from taxable profits (article 46 CITC) during the following six years, provided indicative methods are not applied and there is no change in activity. This last condition may be waived by the Finance Minister. However, when the taxpayer benefits from a tax exemption, tax losses are not deductible.

Profits of non-resident entities with a permanent establishment in Portugal are also taxed, using the rules applied to resident entities (article 3 n. 1 c) CITC).

Resident entities that do not exercise the aforementioned activities as their main activity, are taxed on their global income - the sum of the income that corresponds to the personal income tax code categories (articles 3 n. 1 b), 47 CITC).

Determining taxable profit is done using the aforementioned rules of CITC.

Non-resident entities with no permanent establishment in Portugal are taxed according to the rules established for the corresponding categories of personal income tax (articles 3 n. 1 d) and 50 CITC).

The concept of permanent establishment is similar to the concept of the double taxation agreements. Besides the existence of a fixed place of business, it covers non-residents exercising their activity in Portugal through employees contracted for that purpose, during a period not inferior to 120 days during a

¹⁰ ALBERTO XAVIER, cit., 373-375.

¹¹ See M.H. FREITAS PEREIRA, *A Base tributável do IRC*, in *Ciência e Técnica Fiscal* n. 360, 1990, 120-123.

12 month period (article 4 n. 7 CITC). Doubts were raised as to whether this definition covered preparatory activities, contrary to what is stated in double taxation agreements.

As above mentioned in point 2.1.5., articles 87-90 of the General Tax Law regulate the circumstances under which taxable profit may be determined by indirect methods.

2.2.3. Tax rates

The rate of corporate income tax for resident entities and non-resident entities with a permanent establishment in Portugal is 34%.

Non-residents without a permanent establishment in Portugal are generally taxed at a rate of 25%, although other rates are applicable to certain types of income.

Corporate income tax rates

<i>Residents and non-residents with a P. E.</i>	<i>Dividends paid from a resident affiliate to a parent-company resident in another Member State</i>	<i>Residents not exercising, as main activity, a commercial, industrial or agricultural activity</i>	<i>Non-residents without a P. E.</i>
34%	10% (until 31st. Dec.)	20%	24% (as a rule)

Corporate income tax rates

Non-residents without a P. E. - special rates

<i>Intellectual and industrial property income and royalties</i>	<i>Use of agric., indust., comm. and scientific equipment</i>	<i>Public debt bonds and other capital income</i>	<i>Gambling, lottery and similar income</i>	<i>Commission payments for acting as intermediaries in contracts</i>
15%	15%	20%	35%	15%

2.3. Partnerships

Portuguese tax law has a partial acceptance of the distinction between partnerships and stock corporations.

What are called "professional companies" are one example of direct taxation of the company partners. The required condition for applying this regime is that all the partners should exercise the same profession and work in the same activity, so that they would be individually taxed under the independent income category of PIRC.

For example, if all the partners of a company are lawyers, they have a special tax regime. The company's profit is calculated using the same rules as

other companies (the rules of the CTC), but this will then be attributed to each partner and taxed using progressive rates.

The same regime applies to family-run companies that merely manage immovable property.

2.4. *Double economic taxation of corporations and partners*

Neither unincorporated companies nor partnerships are subject to double taxation.

Corporate profits are subject to double taxation when distributed. However, resident beneficial owners are entitled to a tax credit worth 60% of corporate income tax corresponding to the dividends distributed to the taxpayer and within the limits established by law.

III. Transfer and liquidation of businesses

1. Transfer of individual businesses

In the event of transfer of the business, taxation must be made according to the CTC (as stated in article 31 PTTC), with the necessary adaptations. However, if the assets of the individual enterprise are transferred to the individual's private property, the value of the assets corresponds to the market value at the time of the transfer.

2. Transfer of shares and liquidation of the company

Capital gains from the sale of shares by taxpayers (resident or non-resident) are not taxed if the shares were owned for a period of more than 12 months.

If they are taxed, article 75 PTTC establishes a special final tax rate of 10% for both resident and non-resident taxpayers, even though resident taxpayers may opt to include capital gains in other categories of income and subject them to the progressive rate. This tax rate is also applicable to the sale of participation in limited liability companies.

Given this favourable tax regime, profits are frequently not distributed until after the shares are sold.

For the same reason, enterprises are usually transferred through the sale of shares. Furthermore, this transfer is tax exempt for gifts and inheritances.

In any case, ownership of the company itself may be transferred. If this happens, the different elements (assets) of the company are separated and then taxed according to the rules of the CTC (article 17 and following CTC). If the transfer later implies liquidation (article 65 CTC), the profits are taxed at the CTC flat rate of 34%, and if liquidation implies division of net wealth among the partners, all capital gains resulting from the operation are taxed under article 67 CTC, at the mentioned rate.

Mergers, demergers, capital inflow and share swaps have a neutral tax regime, covering companies and partners resident in different member-states, as it results from the harmonised community regime (EEC Directive 434/90). The tax regime applicable to these operations, when the involved taxpayers are resident in Portugal is the same.

IV. Change of legal status

a) If the assets attached to the commercial, industrial or agricultural activity exercised by an individual are transferred to a corporate enterprise, there is a special neutral regime of non-taxation (articles 68-A CTC and 36-A PTTC).

This regime is applied if the following conditions, among others, are observed (article 36-A n. 1 and 2 PTTC):

- the beneficial entity must be a resident company, with effective management in Portuguese territory;
- the individual transferor must own at least 50% of the company capital;
- the activity exercised by the company must be substantially the same as that exercised by the individual;
- the elements (assets and liabilities) transmitted must be registered with the same value;
- the participations received by the individual must be recorded at their net value;
- the assets transferred may not include capital gains resulting from the allocation of private real estate to the commercial, industrial or agricultural activity, nor resulting from allocation of rural property to commercial or industrial activity, as the taxation of these gains where postponed until the sale of these assets to a third person (article 10 n. 3 b) PTTC and article 36-A n. 2 PTTC).

Losses may be transferred to the company up to a 6-year period, provided taxation is based on real income, and up to 50% of the taxable profit.

b) Transformation of companies neither determines a change of tax regime nor any other tax consequence unless a civil law company is transformed into a commercial company. In this case, during the tax period of transformation, taxation adopts the rules applied to partnerships (article 61 CIRC).

Besides, losses may be transferred to the company up to a 6-year period, provided taxation is based on real income, and up to 50% of the taxable profit.

V. Anti-abuse measures

Most of the anti-abuse measures are applicable to relations between a resident and a non-resident entity:

1. non-deductibility of payments made by a resident company to a non-resident individual or a non-resident company subject in the respective country of residence to a tax rate lower than 20% (article 57-A CIRC);
2. resident partners of non-resident companies located in countries applying the mentioned tax rates are taxed directly on the profits. The resident partner must own at least 25% in the non-resident company, or of at least 10% if over 50% of the non-resident company is owned by resident partners (article 57-B CIRC);
3. Undercapitalization is not allowed when a resident taxpayer has excessive debts to a non-resident entity with which there are special relations. Deduction of interest is not allowed in those cases (article 57-C CIRC).

Only a few anti-abuse measures are applicable to relations between residents, even though they also apply to permanent establishments of a non-resident company:

1. Hidden distribution of profits, through company distribution of money or assets to the shareholders, for whatever reason, is not recognised as a reduction in the company's assets (article 24 n. 1 c) CIRC). Restrictions with the same objective on the attribution of bonuses to the partners were introduced in the 1999 budget:

2. there are also some restrictions on recognising expenses as costs, if they are connected with the partners' juridical sphere, and tax penalties on representation costs, such as parties or travels offered to clients;
3. the general regime of transfer pricing (article 57 CIRC), allowing the tax administration to correct the taxable profit whenever there are special relations between the company and other persons also covers of hidden distribution of profits.