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A Critical Overview of the Treatment of Tax Losses in Portugal[*]

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Abstract

Portugal has long been at a loss to establish a coherent and balanced framework for treating tax losses. As a consequence, the terrain has been fraught with pitfalls as well as some opportunities. This practice article seeks to summarize and put into critical perspective the basic rules that limit the allowance of corporate losses for income tax purposes and concludes that, in spite of ever mounting limitations on the deduction of financial losses and on the carry forward and inter-company transfer of losses, group relief continues to provides a safe haven for efficient tax management.

Há muito que o sistema fiscal português anda perdido na senda de um regime de perdas fiscais equilibrado e coerente. Dessa errância tem resultado um campo minado de alçapões, mas que também encerra algumas oportunidades. O presente artigo, de índole prática, visa condensar e perspectivar de modo crítico as principais normas de IRC limitativas da dedução de perdas e do reporte e transmissão de prejuízos, para concluir que, apesar do crescente muro de limitações que vem sendo erguido entre o rendimento real e a matéria colectável, o regime especial de tributação de grupos de sociedades tem permanecido surpreendentemente incólume às investidas do administrador-legislador fiscal português.

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Contents:

1. Basics
2. Loss carryover
3. Early expiration of losses
4. Group relief
5. Transfer of losses
6. All in all

1. Basics

Tax losses of resident companies and of local permanent establishments of non-resident companies are derived from accounting losses recognized in the profit and loss statement and other net decreases in equity recognized in the balance sheet, unless disallowed or adjusted under specific tax provision.

Tax losses may exceed accounting losses typically in the case of realized capital losses, because capital tax losses are computed by adjusting the accounting cost base for inflation.

Normally, current tax losses will fall short of accounting losses due to specific legal provisions disallowing accounting expenses or losses for tax purposes. Since the 1989 enactment of the existing corporation income tax code, the list of disallowed expenses and losses has grown considerably to include items such as:

- amortization of goodwill[i];
- damage compensation for insurable events[ii];
- write-off of accounts receivable outside the context of judicial enforcement proceeding[iii];
- municipal surcharge tax on corporate income[iv];
- 50% of net losses realized on the disposal or liquidation of equity investments in companies[v].

Moreover, capital losses realized on the following events are fully disallowed:

- on the sale of shares to a related party[vi];
- on the sale of shares to a resident of black listed jurisdiction[vii];
- on the liquidation of equity investments held for less than three years[viii];
- on the sale of shares held for less than three years by a company which has acquired the same from a related party, from a resident of a black listed jurisdiction or from an exempt Portuguese resident[ix];
- on the sale of shares held for less than three years after the seller has changed its tax status from one which would have disallowed the loss[x].

This growing list of disallowed losses is commonly attributed to unwillingness or sheer inability on the part of the tax administration to properly enforce existing transfer pricing and anti-abuse provisions. However, equal blame may be placed on the judicial system for failing to reign in on legislative developments that tend to cross the boundaries of constitutional safeguards.

The same disproportionality in the limitations on current tax losses can be found in the framework of loss carryover provisions.

2. Loss carryover

Net tax losses in a given period may be carried forward to offset any tax profits realized in any of the six years thereafter[xi]. Currently, tax rules only allow for the carrying back of losses realized in the second year of a liquidation process, against profits realized in the first year of the same liquidation[xii].

Under the current statute of limitations, losses, as well as profits, may generally be challenged and corrected by the tax administration over a period of four years. Exceptionally, where losses are carried forward to the fifth or sixth subsequent tax years, they may also be challenged and corrected by the tax administration within that period[xiii]. Thus, the tax administration may correct tax losses realized up to 6 years prior.

3. Early expiration of losses

Losses that could otherwise be used within the six-year carry-forward period cease to be deductible against subsequent profits upon the occurrence of any of the following events and in the absence of a special waiver granted by the tax administration on the grounds of "economic interest"[xiv]:

- If the company changes its *statutory objects*; or
- If the company substantially changes the nature of its *business activity*; or
- If 50% or more of the *ownership* of the company's capital or the majority of its voting rights change hands.

Each of these three cases of events presents its own individual challenges. For instance, because the change in statutory objects is not qualified under the relevant legal provision, it follows that *any* change, no matter how trivial, can technically cause losses to expire.

Companies are often led to amend or adapt their statutory objects in order to comply with particular legal or contractual requirements, such as for the purpose of qualifying for a licence or for a bid, and many times do so without realizing that this may have any tax implications. However, under current rules, this will – in the absence of leniency on the part of tax inspectors – lead to expiration of losses, even where company objects have simply been clarified or extended in the bylaws, without any substantial change in business activity.

Even though a waiver from loss expiration can be granted in cases of justified economic interest, such a waiver has to be applied for *prior* to implementing those changes, with no excuses for late awakenings. The fact remains that companies will often decide on and execute changes to statutory objects without the scrutiny of tax counsel and without taking those tax consequences into account.

One lesson to be drawn is that companies should adopt a statutory object as broad and varied as possible, in order to limit the need for subsequent changes to its wording.

In sharp contrast to the formal and literal scope for applying the statutory objects rule, another rule – the business activity rule – relies entirely on substance. In order for the losses of a company to expire as a result of a change in business activity, this change will have to be substantial *and* a change to the nature of the activity concerned. Changes of a lesser magnitude will leave carried forward losses unharmed.

However, neither the law, nor the tax administration or the tax courts have so far provided any meaningful guidance as to what would constitute a "substantial change of the nature of a business activity". It follows that a company which, say, turns around a loss-making division for manufacturing radios into a profitable computer assembly division, cannot be certain that it is not risking expiration of tax losses. Even though the nature of the activity can be regarded as unchanged under a broad category (i.e. industrial production of electrical equipment), the conclusion may be different for narrower categories (e.g. manufacturing vs. assembly). The Portuguese tax courts are currently reviewing a case where a tax inspection has disallowed losses from real estate rental activity to be deducted from profits subsequently realized on the sale of the same real estate.

As in the case of changes to the statutory object, a company may also obtain a loss expiration waiver for changes in business activity, provided it applies for the waiver before implementing those changes and is able to justify their economic interest. Even if the intended changes to business activity are less than substantial, a waiver application may be the best insurance policy against future challenges to loss utilization.

A waiver may, however, be more difficult to justify on the grounds of economic interest in the event of a change in ownership or voting rights of the loss carrying company. This third and latest loss expiration rule was added in 2005 to prevent the trading in tax losses, but has a reach entirely disproportionate to its purpose.

Under the change of ownership rule, losses will expire if, say, a company is owned by two individual shareholders, each with a 50% stake, and one of them dies. This event will trigger the expiration of

losses carried by the company regardless whether the share of the deceased is acquired by his family or by the surviving shareholder, or whether that share is simply redeemed.

Even in cases of corporate ownership, losses may expire simply by virtue of a group restructuring exercise, because the maintenance of the indirect ownership structure is not taken into consideration. Even though a waiver will be called for in these circumstances, it will only be granted if applied for in advance.

4. Group relief

In contrast to the above limitations to carrying tax losses forward within the company where they originated, corporate income tax rules allow for these same losses to be pooled with profits and losses of other companies within the same tax group or to be carried forward as tax group losses, regardless of any differences in statutory objects or business activities between group companies.

Two or more resident companies[xv] may apply for tax group relief where one of them (the controlling company), directly or indirectly owns at least 90% of the equity and controls more than 50% of the votes in the other company or companies (the controlled companies) and is not in turn controlled by another company in the same way[xvi]. A tax group must include all companies meeting the criteria for inclusion. Tax group companies that cease to meet the criteria for inclusion must leave the tax group.

Companies in a tax group surrender their current tax profits and losses to the controlling company, which computes tax over the sum of all individual tax profits and losses within the group. If the sum is a net loss, it can be carried forward as a group tax loss and be deducted against a group profit within the ensuing six-year period.

Tax profits and losses pooled under a tax group are derived exclusively from individual company accounts, with no consolidation of intra-group transactions[xvii]. Thus, tax losses generated from intra-group transactions are also pooled, unless they are disallowed (see above).

Tax losses already carried by a tax group company when joining the tax group are deducted, within their general 6-year carry-forward period, against group tax profits but only up to the amount of current tax profits surrendered by the same company[xviii]. If these tax losses are not fully utilized at tax group level, the company can continue to carry and utilize them after having left the tax group.

Tax losses realized during the tax group relief period but not utilized to offset group profits cannot be claimed back by the originating company upon leaving the tax group. In addition, whenever a company leaves the tax group before its losses have been fully utilized at group level, a proportional amount of group tax losses expire[xix].

Even though tax losses generated within a tax group can only be carried forward within the same tax group, they will not expire in the case of changes to the statutory objects or in the business activity of any of the group companies, including those where those losses originated. Tax group relief is therefore an alternative to the waiver from tax loss expiration rules (see above), as well as to the authorization to transfer losses in a company merger (see below).

5. Transfer of losses

Tax losses carried by a resident company[xx] may be transferred to another company in the case of a liquidating merger or division, subject to authorization by the tax administration on the grounds of demonstrated "sound economic reason" for the restructuring and the related "medium or long term advantages to the productive structure" [xxi]. This applies also to mergers or divisions within a tax group (see above) in order to transfer losses generated prior to the group relief period.

If an authorization to transfer losses has been granted, the beneficiary company may utilize them to offset current profits within the remaining carry-forward period, subject not only to general rules and limitations (see above), but also to any specific limitations which may be set forth by the tax administration on a case by case basis[xxii].

Currently, all authorizations to transfer tax losses abide by the following limitations prescribed under a tax administration circular[xxiii]:

Transferred tax losses may not be used in excess of the incremental taxable earnings of the companies that survive the reorganization. Incremental taxable earnings are defined as the total increase in the taxable earnings of all companies that survive the reorganization over the total taxable earnings of all companies that took part in the reorganization in the period ended immediately prior to it, with the exception of those of the company where the tax loss originated.

Transferred tax losses may also not be used in excess of the proportion between the net equity value of the tax loss originator and the aggregate net equity value of all companies that took part in the reorganization, as determined by the last balance sheet before the reorganization. This rule effectively prevents the transfer of tax losses originating in a company that has a negative net equity value.

Both limits apply on a yearly basis. The combination of the two rules means that the lesser of the two limits prevails. For example, in a merger, into a new company X, of companies A, B and C, all having the same positive net equity value, and where A and B had a combined 100 in pre-merger taxable earnings and C 100 in tax losses, the newly formed beneficiary company X may use only up to 33.33 in tax losses each year against yearly taxable earnings exceeding 100.

If, however, company C not only has losses but also negative net assets (equity), company X will not be able to utilize any of those losses. Alternatively, however, these losses could be utilized if, instead of merging A, B and C, the three companies were to form or integrate a tax relief group (see above).

6. All in all

Losses realized by Portuguese resident companies and permanent establishments of non-resident companies suffer from excessive and disproportionate limitations to being allowed into the tax base. This applies not only to current losses but also to carry forward losses under changing circumstances.

These limitations reflect serious difficulties on the part of the tax administration to enforce existing transfer pricing rules and anti-abuse provisions.

The existing group relief scheme, however, offers an interesting respite and an appealing safe harbour from those limitations, especially for more complex company structures.

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[i] Regulation 2/90, of 12 January 1990, article 17.3

[ii] CIT Code, section 42.1.e.

[iii] CIT Code, section 39; However, receivables may be fully expensed over a period of 24 months as a provision for doubtful accounts, under certain circumstances; see CIT Code, section 35.

[iv] CIT Code, section 42.1.a

[v] CIT Code, section 42.3

[vi] CIT Code, section 23.7

[vii] CIT Code, section 23.7

[viii] CIT Code, section 75.2.b

[ix] CIT Code, section 23.5.

[x] CIT Code, section 23.6.

[xi] CIT Code, section 47.1.

[xii] CIT Code, section 73.2.b.

[xiii] General Tax Code, section 45.3.

[xiv] CIT Code, section 47.8.

[xv] Even though existing rules exclude permanent establishments of non-resident companies from joining a tax group, this would appear to be incompatible with the overriding freedom of establishment under article 43 of the EC Treaty.

[xvi] Limitations apply (CIT Code, section 63).

[xvii] But adjustments are made for intra-group dividends that would not fall under a participation exemption (CIT Code, section 64.2).

[xviii] However, a company cannot be part of a tax group if it has accumulated tax losses over the three previous consecutive years, unless this company has been controlled by the controlling company for more than two years (CIT Code, Section 63.4.c).

[xix] CIT Code, section 65.1.d. Even though the letter of the law is not conclusive, the amount of group tax losses which expire should be the proportion of unutilized tax losses surrendered to the tax group by the exiting company over the total amount of unutilized group tax losses.

[xx] Or a permanent establishment of a company resident in another EU member state.

[xxi] CIT Code, section 69.

[xxii] CIT Code, section 63.4.

[xxiii] Circular n.º 7/2005, of 16 May.