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Foreign Exit Taxes and Entry in Portugal – The Case of the NHR Regime

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Exit tax is a name for tax paid when a person shifts tax residence from the former country of residency to another new country of residence. When a person relocating to Portugal suffers any type of exit taxation levied abroad this may likely raises complex issues, especially with regards interaction with the non-habitual tax resident's (NHR) regime.

What are Exit Taxes?

In terms of scope, there are several types of exit taxes but the most common is levied only on capital gains arising from unrealized gains from shares like in Spain or France, or only substantial shareholdings like in the Netherlands, or also imposed on income from stock options or on accrued contingent compensation, like in Singapore.

We should first distinguish: (i) exit tax - as an immediate tax on the unrealized appreciation of assets levied on departure date, even if sometimes combined with extended payment terms or even contingent upon realization; (ii) trailing tax or extended tax liability –which is a tax imposed on non-residents after emigration that extends beyond the scope of the tax applicable to ordinary non-residents by taxing gains and/or income when the property is actually sold and the gain actually realized or income collected.

"Exit tax is an immediate tax on the unrealized appreciation of assets levied on departure date even if with extended payment dates or even contingent on realization"

This difference is important because an exit tax is levied immediately before emigration, that is whilst the taxpayer is still a tax resident of the former country and hence a double tax treaty concluded between that country and Portugal technically does not prevent such domestic taxation to occur. This is also why there is no mention to the exit tax in tax treaties.

Conversely, the trailing tax on former residents generally extends tax liability for a period of time (generally 5 to 10 years of change of residence) but to be effective the prior country of residence needs to reserve its right to tax the former tax residents under its tax treaties.

For example, Canada is an example of a country with treaty policy effectively to impose a trailing tax with respect to taxable Canadian property, including in the tax treaty with Portugal. Other examples, include tax treaties with the Netherlands and Ireland that allow certain taxing rights on prior residents after relocation to Portugal.

From a tax policy perspective, there are several reasons may be put forward for certain countries imposing an exit tax (or trailing tax) on individuals and those range from wishing to retain taxing jurisdiction before untaxed accrued income and/or appreciation in value changes tax jurisdiction and becomes untaxed, deny former residents any unintended benefits flowing from applying non-resident rules or express some sort of disapproval for those who wish expatriate or leave the jurisdiction. The use of exit tax on individuals is widespread and Finland is the latest example of countries proposing the inclusion of an exit tax on individuals on the increased value of their non-real estate assets.

"The other side of the coin for an exit tax on accrued income or gains is the tax treatment granted by the new country of residence, in this case Portugal"

The following analyses only the tax issues arising from foreign exit taxes (not trailing taxes) for a person relocating to Portugal.

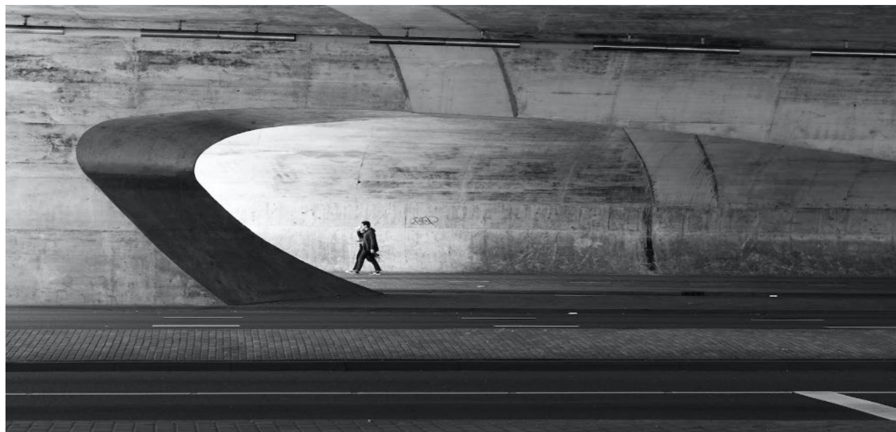
What happens in the Arrival Country?

Indeed, the other side of the coin for an exit tax on accrued income or gains is the tax treatment granted by the new country of residence, especially important for a country like Portugal that, for example, taxes the gains derived upon realization from the sale of shares of foreign shares generally at a 28% rate.

Even if we are dealing with two different taxes levied at different moments by two different countries (i.e. exit tax on the expatriation and capital gains tax on realization), we are still dealing with the same income potentially being taxable in the hands of the same person by more than one country. Any mismatch would lead to potential juridical double taxation.

Before addressing the specific case of Portugal, we should highlight that several technical approaches may be possible when gains are realized on previously acquired assets in the hands of a new resident.

1. One approach for the new country of residence would be deeming the cost of such assets to be the exit tax values for purposes of determining gain/loss on future dispositions. This new tax basis would be justified to avoid double taxation and eliminates tax consequences of any pre-entry appreciation in the assets' value.



2. Another approach would be to recognize the exit tax as a tax levied on the same item of income and grant a tax credit of the tax levied against the tax due on realization. This tax credit would be justified as the exit tax was effectively levied abroad over the same item of income.

3. A final approach (for a country having exemption method) is to recognize the partial taxation levied via the exit tax as being a tax levied in accordance with the tax treaty (i.e. because effectively it is not disallowed) and hence the income accruing until the expatriation date would be exempt of taxation in the new country.

We believe a "no solution" that "shuts the eyes" to the issue and simply rejects any type or form of relief is unacceptable.

If no solution is available, the likelihood of double taxation increases exponentially.

What is the position in Portugal?

The question to address is the correct tax treatment in Portugal for an NHR when a foreign exit tax on unrealized is levied by a foreign country seeking to preserve their taxing rights before such person actually moves to Portugal.

To our knowledge there is neither an express provision nor any administrative guidance or rulings issued by Portuguese tax authorities on this matter and therefore the first approach is a statutory interpretation of the Portuguese domestic tax rules.

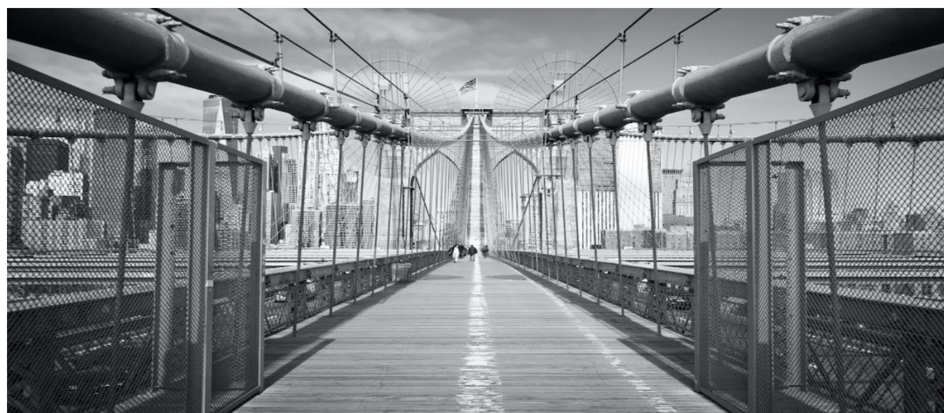
Naturally a "no solution" whereby the new country of residence (Portugal) simply "shuts the eyes" to the issue and simply rejects any type or form of relief is unacceptable. Taxing windfall gains arising from persons relocating to Portugal and then ignoring lawful taxes effectively levied abroad would never be the right policy for a country that wants to attract talent. Portugal should tax the correct fair share of income, neither more nor less.

On this point it is worth noting that Portugal adopted domestically the credit method to eliminate international double taxation. For non-habitual tax residents (NHR) there is a possibility to apply for an exemption of foreign source income or gains to the extent that:

(i) in the case of active income (e.g. employment) the foreign tax was effectively levied in accordance with the tax treaty with the other contracting state or the OECD Model Convention (in case there is no such treaty in place);

(ii) in the case of capital gains the foreign tax may be taxed in accordance with the tax treaty in place with the other contracting state or the OECD Model Convention (in case there is no such treaty in place).

The best way to undertake an exercise of interpretation of the rules is to set the 3 options against an actual example.



Mr A residing in exit country B owns 100 shares of a company resident in B acquired for €100 and he moves to Portugal when the shares have a value of €200. Mr A sells 2 years later as resident in Portugal the shares for €300. The tax treaty with country B allocates the taxing rights on the alienation of shares exclusively to Portugal. Country B exit tax regime taxed Mr A as having realized a gain of €100 taxed at 20% (i.e. €20 of tax) notwithstanding Mr A not having yet realized the gain when he departed the country.

1. If Portugal treats Mr. A as having acquired the shares for €200, Mr. A would be subject to tax at a 28% rate in Portugal on a gain of €100 (€300 - €200) at the time of sale corresponding to €28 of tax. As €20 of tax was already paid under the exit tax in Country B, then no double taxation occurs. The problem with this solution is that the language of the Portuguese tax code seems to indicate as acquisition value the "historical cost" and the margin to consider the exit tax as a recognizable "expenses necessarily and actually incurred" is rather limited.

2. If Portugal treats instead Mr. A as retaining the historical cost of €100, Mr. A would be subject to tax on a gain of €200 at the time of sale corresponding to €56 of tax payable. Since Country B taxed the unrealized gain of €100 upon departure, double taxation would occur. This double taxation should be eliminated by Portugal providing a tax credit of the €20 of tax levied by Country B and the final tax due in Portugal would be reduced to €36. The unilateral tax credit provision in Portugal provides that "recipients of different categories of income obtained abroad are entitled to a tax credit for international double taxation" and the language of the provision at no moment excludes the case of taxation arising abroad through an exit tax mechanism. The exit tax is a recognized case of "international juridical double taxation" that should be effectively resolved via the tax credit mechanism.

"an emigration country cannot be restricted from applying an immediate exit tax if it has entered into a tax treaty based on the OECD Model."

3. If Portugal denies the unilateral foreign tax credit and still treats Mr. A as retaining the historical cost of €100, Mr. A (if qualifying as an NHR) could still apply for the exemption method on all or part of the income that was taxable in the other jurisdiction via exit tax. Under this approach, Mr. A would exempt the income arising/accruing before the relocation to Portugal and subject to tax at a 28% rate in Portugal only a gain of €100 (€300 - €200). The language of the domestic provision for the NHR exemption method for capital gains refers to "foreign income that may be taxed in accordance with the tax treaty in place with the other contracting state". On this point, we consider that it has been widely considered that exit tax is consistent with the OECD Model and hence allowed. In addition, the treaty term "alienation" in Article 13 of tax treaties may be interpreted as considering any taxation of hidden reserves/unrealized appreciation by way of change of residency as capital gain even if there is no change of ownership.

A side note to mention that the outcome of tax credit or exemption (in the case of NHR) should be the same if, for example, the exit tax is levied on certain types of deferred compensation (e.g. stock options) to the extent that employment services have been rendered in that exit country and hence taxable by that country under Article 15 of the tax treaties (i.e. country where the relevant employment was exercised).

What about EU Law?

From an EU Law perspective, it has been established in EU case law that exit tax on individuals is compatible with the EU law to the extent deferral of payment is granted until realization and decreases/increases are taken into account as in the domestic situations.

The next normal step – if such exit tax is lawful – is to consider that arrival country perspective (i.e. Portugal) not providing relief for such exit tax could affect the behavior of taxpayers or market access and could constitute a restriction to the free movement rights ensured by the EU law. The discussion from EU Law lens regarding double taxation on exit taxes is not yet closed because some could argue that the disadvantage results from parallel exercise of tax jurisdiction by exit country and residence country not considered contrary to the free movement of capital.

Conclusions

We believe as extremely relevant to counter positions that consider that there is a mismatch in Portuguese Law without a clear-cut legal solution or that only mutual agreement procedure (MAP) would solve the case of foreign exit taxes.

Indeed, we consider there is sufficient scope in the language of the applicable Portuguese domestic law to either provide a tax credit for the exit tax levied abroad under the unilateral tax credit rules or, in the specific case of NHRs, apply the exemption method on the income accrued and tax abroad, as the tax treaty does not prevent such tax to be levied.

When dealing with NHR, we should highlight that the domestic exemption system was ultimately designed to simplify the final outcome of a resident deriving income from foreign sources that in accordance with a tax treaty may be taxed in such foreign country, without prescribing how such foreign tax should be levied (e.g. withholding tax, exit tax or other forms of advance taxation) or resulting in timing mismatches.

Therefore, we believe that the outcome of neutralizing any foreign exit tax levied abroad is the only solution in Portugal that is compatible with the language and spirit of the domestic rules for elimination of double taxation.

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