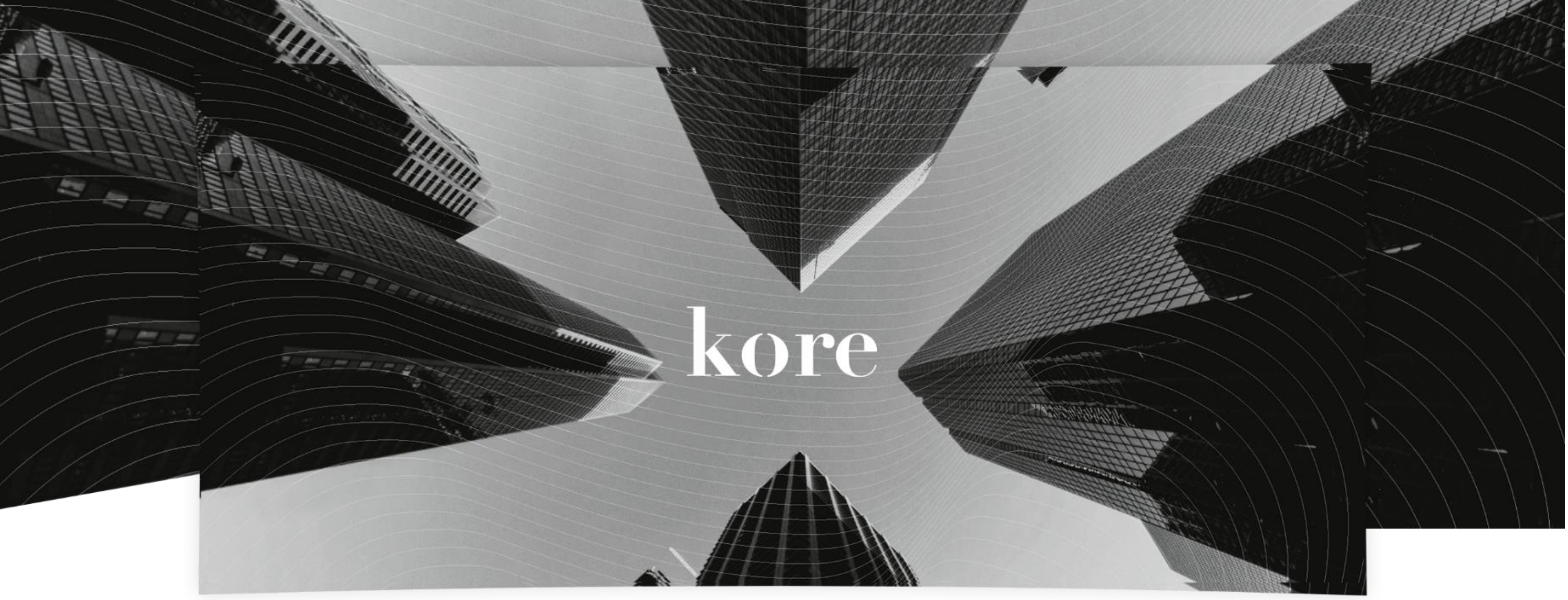

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Taxation of Trusts in Portugal – Does NHR regime make a difference?

By Kore Partners

ON THIS ISSUE

With the international success of the non-habitual residents' ("NHR") regime attracting tax residence of individuals from many jurisdictions, the question of the tax treatment of settlors and beneficiaries of trusts when they come to live in Portugal was bound to be raised.

When granted, the NHR regime may provide for full exemption of certain foreign-source income received. However, the regime operates complex exemption rules, making it conditional on several factors, such as the country of source, the category of income and the provisions of an applicable double tax treaty. Putting trust taxation in Portugal in perspective is therefore critical to the one considering moving to Portugal and having a connection to a trust.

Attention is necessary because Portugal as a civil law country does not contain a set of consistent or developed legal rules relating to trusts. At least from the tax perspective new rules dealing with income and gains arising in Portugal in relation to fiduciary structures were adopted in 2015 and brought much wanted clarity to certain situations involving trusts.

> ***"The question of the tax treatment of settlors and beneficiaries of trusts in Portugal is recurrent"***

How is trust income taxed in Portugal?

Portuguese tax law deals with the qualification of income distributed from foreign trusts by considering they fall within the category of investment income which is generally subject to tax at the 28% rate in Portugal (unless option to tax at progressive rates is exercised by taxpayer – option seldom used). If paid by trusts considered domiciled in a blacklisted jurisdiction an aggravated tax rate of 35% may apply to those distributions. The rules do not specifically distinguish capital or income distributions.

The concept of source of the income in trusts is not defined but tax law does accept that for a trust what is important is the place of effective management that corresponds to the domicile of the trustee. The law applicable to the trust and the tax nature of the trust in the other jurisdiction may be relevant for other matters.

While distributions are taxed in the hands of the recipients, Portugal treats differently income arising from the termination, extinction or revocation of fiduciary structures, which are different depending on the fact whether such income is received by the trust settlor or by a true beneficiary (not-settlor). Two possible outcomes may arise:

"Distributions of trusts are always taxed, whilst the income from termination of a trust may have different tax consequences"

1. If the recipient is the settlor, we have a chargeable capital gain determined as the difference between the termination proceeds less the value contributed to the trust. Any gains for the settlor will be subject to income tax at the 28% rate or 35% rate if trust is domiciled in a blacklisted jurisdiction.
2. If the recipient is a beneficiary but not a settlor, the proceeds value (cash or assets) attributed to the such beneficiary are excluded from income tax being instead qualified as gratuitous transfer only subject to 10% Stamp Tax ("ST"), if certain territorial criteria connecting the transaction to Portugal are fulfilled. Practice has demonstrated that in many cases the territorial nature of ST results in no taxation arising from termination of foreign trusts with Portuguese resident beneficiaries.

There has been a series of rulings covering the application of the exclusion of taxation in case of termination, extinction or revocation of trusts for non-settlors and outlining the boundaries of when an asset may be considered falling outside the scope of ST.

As regards trust undistributed profits and when income of trusts consist predominantly passive income, the potential application of controlled foreign corporations' ("CFC") rules requires a careful analysis of the type of trust and its regulations to determine control features either by settlor or beneficiaries resident in Portugal and if deferral applies until actual distribution. The irrevocable and discretionary nature of a trust should remove the CFC risk. Another practical point relates to exchange of information, as we also see increased scrutiny from the Portuguese tax authorities based on the automatic information exchanges that frequently gives rise to reporting mismatches.

How trust distributions are treated under the NHR regime?

Foreign investment income is exempt in the hands of an NHR in Portugal only if an applicable tax treaty allows the source state to tax the income. It is not necessary to demonstrate effective taxation but only that taxing rights are attributed to the source state.

This raises a problematic issue in most cases for distributions of trusts requiring a technical analysis if income from trusts may be eligible for exemption.

Tax treaties and the OECD Model and its Commentaries still give virtually no or limited guidance as to the application of tax treaties to trusts, trustees or their beneficiaries. For example, when a trustee receives various items of income and then makes payments to beneficiaries in another jurisdiction at his discretion, two possible solutions could arise:

a. The first solution is that the payment to the beneficiary retains its original nature. Thus, for example, if the trustee received a dividend from State S, the payment to the beneficiary is also regarded as a dividend derived from a company in State S. This raises obvious difficulties of identification, particularly where the trustee has a power to accumulate income and makes a payment several years after its receipt.
b. A second solution is that the payment to the beneficiary does not fall within one of the specific Articles (i.e. Articles 6 to 20) of the OECD Model but falls under its Article 21 (Other Income). There is legal basis for assuming that this is the correct answer to the classification of income paid out of a trust and most of the tax treaties that follow the OECD Model result in the income being taxable only where the beneficiary is resident.

"NHR exemption is part of the elimination of international double taxation and trust distributions are rarely exempt under the regime"

The general understanding in Portugal has been that distributions from trusts would fall under the "Other Income" with the taxation rights (in most cases) then being exclusively reserved to Portugal and no NHR exemption being available.

Only some states for example make express provision in their tax treaties for trusts. For example, the United States generally provide in their treaties that a trust is within the definition of a "person". The United Kingdom provides in several of its treaties (not the Portuguese) that income paid out of a trust is excluded from the equivalent of Article 21 (Other Income). Only very few countries (such as Brazil, US or Singapore) still provide a shared taxing rights as regards the "other income" article.

What about setting-up trusts whilst resident in Portugal?

Unfortunately, the contribution of assets or cash to trusts is not regulated under Portuguese tax law and therefore tax effects will depend largely on the residence of trustee and beneficiaries, location of assets or cash, as well as the nature and type of the underlying trust.

Since it is generally not recommended to add Portuguese assets (real estate or not) to a foreign trust, in many instances it should be possible to minimize any tax effects of settling trusts in favor of beneficiaries.

Final take and summary table

The use of trusts in a civil law jurisdiction like Portugal requires careful review and attention not only to the tax issues. Experience indicates that non-tax reasons are sometimes the driver for setting-up a trust. Those issues should be reviewed and alternatives to trusts should also be explored, such as the life insurance policy, family charters and other legal instruments.

The following table outlines the outcome applicable in Portugal to Portuguese tax resident settlors and beneficiaries of foreign trusts.

Type of situation	Settlor	Beneficiary
Contribution to a Trust (as resident in Portugal)	Depends on the persons, location of assets and type of trust (may be taxable or not)	Not taxable until distributions are received
Undistributed Trust Profit	Deferral. Potential CFC risk that needs to be assessed when control features exist for Settlor	Deferral. Potential CFC risk that needs to be assessed when control features exist for Beneficiary
Periodic Distributions	28% taxation (or 35% for trust domiciled in a blacklisted jurisdiction)	
NHR exemption	Not applicable in most cases, unless trusts are expressly covered, or “other income” article provides for shared taxing rights	
Trust Termination	28% taxation (or 35% for trust domiciled in a blacklisted jurisdiction)	No income tax and only 10% Stamp Tax if territorial features are fulfilled

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Rua Garrett 19, 2C, Lisbon, 1200-203, Portugal