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DIRECTED RESEARCH: TAX CONSIDERATIONS FOR BUSINESS AND INVESTMENTS IN PORTUGAL AND CHINA

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Abstract

Since the last decade, the level of commercial and investment activities between Portugal and China has entered a new era in terms of intensity and prosperity. With the expectation that more entrepreneurs and investors from the two countries are elaborating their business plans to enter the market of the other country, this paper tries to answer the question of what are the tax related factors and reasonable planning strategies that should be considered to lower the effective tax burden, so as to achieve a higher return on capital and to promote the success of the business.

Keywords: **Corporate Taxation** **Tax Law** **Tax Planning** **Tax Avoidance**

Introduction

The connection between Portugal and China dates back to the sixteenth century with the arrival of Portuguese fleet at Macau. Since then, the commercial and cultural exchange between the two countries have never ceased to prosper, and the scope of business and investment activities has entered a new era since the beginning of the decade, when the two countries began to recognize the economic potential derived from more collaborations, fact which is supported by the trade and foreign direct investment figures that have soared over the past few years. From the perspective of Portugal, China has become its tenth major exportation destination country in 2015, with value of exports amounting to 839 million euros; from the perspective of Chinese capital, Portugal has become one of the most important investment destinations due to its great potential over the energy and finance sectors. In 2011,

China Three Gorges acquired Portugal's stake in utility Energias de Portugal (EDP) for 2.7 billion euros, marking the first step of Chinese direct investment in Portuguese companies, followed by China's State Grid's acquisition of 25% of Portugal's national power grid in 2012, Fosun International's acquisition of control of Portugal's largest insurance group Caixa Seguros in 2014, and the acquisition of BESI by Haitong Securities for 379 million euros in 2015. In 2016, China's Fosun acquired 16.7% of stake in Portugal's largest listed bank Millennium BCP, and Minsheng Bank was involved in the bidding for acquisition of Novo Banco.

With the expectation of more business activities are to take place in the future, entrepreneurs and investors may have started to elaborate their business plans. Among all the factors that impact the plans' viability, taxation is one of the most important to be considered. As Underhill pointed out, with the objectives to create value for shareholders and promote the success of company, the directors would have incentives to engage in tax planning as long as its outcome – reducing tax burden to maximize shareholders' profits without significant negative effects – are aligned with such objectives<sup>i</sup>. Moreover, taxation may impact – either facilitate or hindering - the business negotiations, which can be demonstrated by a M&A case where tax burden arising from transfer can affect target company's willingness to reach the agreement with acquiring company<sup>ii</sup>. As a result, companies are motivated to engage in tax planning for better financial outcome or negotiation results, and such planning can be indeed effective as the companies – multinational corporate groups in particular – possess structure flexibility to manipulate legal characterization and tax attributes of

group members and global presence to benefit from tax law differences.<sup>iii</sup>

This paper aims to answer the question of what are the taxation related factors that enterprises targeting business and investing opportunities in Portugal or China should consider so as to elaborate tax efficient business plans, and tries to figure out tax planning strategies that lowers company's tax burden at each of the five stages of typical business cycle – entry, operating, financing, profit distribution and exit. To answer the abovementioned question, this paper adopts the qualitative methodology, presenting and analyzing the tax laws in force and their impact on business decision making, as well as the quantitative methodology, performing calculations to figure out better tax strategies under certain scenarios and demonstrating the superiority of those strategies to cases without tax planning by comparing their effective tax burdens.

## 1. Entry Considerations

The tax strategies of this stage will be tailored to two scenarios - direct entry and entry through merger or acquisition, as such choice in principal depends on the whole business plan and involves more important factors other than mere taxation.

### 1.1 Direct Entry Considerations – Start from Scratch

The choice between setting up branch or subsidiary at this stage constitutes an important consideration because of its tax implications, namely the use of profits and losses generated through the business life cycle.

#### 1.1.1 For Portuguese Companies Targeting the Chinese market:

If the legal form of subsidiary is chosen, its profits will only be subject to Chinese Enterprise Income Tax, whereas business run through branch is subject to tax in both

jurisdictions. Nevertheless an option to exempt such tax is granted in Portugal if certain conditions are met<sup>iv</sup>. In early stage of business usually more expenses than revenue will be incurred, so the focus of planning is to make use of tax losses. Three possible options should be examined to determine the most tax-efficient choice:

Option 1: Operating with subsidiary: The losses generated by a subsidiary cannot be used to offset profits generated by other elements of corporate group, as the Portuguese special group tax regime confines its application solely to groups whose members are all residents in Portugal<sup>v</sup>.

Option 2: Operating with branch whose P/L is exempt: same outcome as the first.

Option 3: Operating with branch whose P/L is not exempt: The tax losses of branch can be used right away to offset profits generated by other elements in Portugal.

Now consider further the profits-generating growth period that ensues. By adopting the first two options, these profits can be offset in China by the earlier tax losses not yet used. Regarding the third one, the option to exempt the P/L of branch cannot be exercised immediately until the profits amounting to the losses used are taxed in Portugal<sup>vi</sup>. A possible tax efficient plan is to register the branch to subsidiary at this stage, so that no further tax burden need to be considered, and the initial losses may still be used in China. To sum up, the third option can be the most tax efficient.

However, double tax treaties will impact cross-border activities. As a projection of headquarter, wherever locates the branch, the treaty used will be the one between headquarters' resident country and the transaction counterparty's resident country, unlike the case of subsidiary. Naturally, favorable tax treaties will impact legal form

choice, which may nevertheless conflict with the abovementioned best option.

#### 1.1.2 For Chinese Resident Companies Targeting the Portuguese market:

Subsidiary's profits will only be subject to Portuguese tax. Branch's P/L will be subject to income tax in both countries due to the absence of option to exempt such P/L in Chinese law. As Chinese tax law does not allow the profits generated in China to be offset by losses generated by branches abroad<sup>vii</sup>, the economic agent might be indifferent to the legal form choice regarding the use of initial losses.

### 1.2 Considerations for Entry through Merger or Acquisition

Merger or acquisition generally involves target enterprise's transfer of assets or equity to acquiring company, where the realization of profits arising from transfer constitutes a taxable event to the target company. Nevertheless, due to the existence of continued business interest before and after the restructuring, tax laws of most jurisdictions grant special tax regime for such events, deferring taxation on profits realized by the acquired company upon transfer, keeping tax basis of asset or equity transferred the same as book value<sup>viii</sup>. This part analyzes the effect of applying special tax regimes by comparing the resulting tax burden with normal tax treatment, the applicability of special tax regimes and possible plans for qualification.

#### 1.2.1 Scenario A: A Portuguese Company acquires a Chinese Company

Chinese general tax treatment stipulates that profits realized from transfer in merger are taxable and tax losses carried forward by the acquired company are not allowed to be transferred to the acquiring company<sup>ix</sup>. For the acquired company, the immediate tax burden and the lost opportunity to use tax losses make the deal less attractive,

while the acquiring company benefits from a higher tax basis of assets transferred because of more deductible depreciation and less capital gains realized in future<sup>x</sup>. The acquisition case is slightly different in that acquired company can still use its tax attributes as the acquisition does not lead to its extinction. For the reorganization to be tax efficient for both sides under the normal tax treatment, a higher transfer price can be considered – as long as such pricing does not trigger anti-abuse measures such as transfer pricing or property value adjustment that will be discussed in detail in latter parts – so that for the acquired company its tax burden can be compensated and the tax losses carried forward may be fully used with this transfer, and for the acquiring company it can take advantage of the step-up of asset tax basis for future tax purpose.

Regarding special tax regime, Chinese rule restricts its application in cross-border restructurings to 3 scenarios<sup>xi</sup>, where only the following is of interest: *A resident enterprise invests in its 100% directly owned non-resident enterprise in the form of asset or equity*. Notice that the tax arrangement in this case is to recognize profits but tax them evenly over a 10-year period instead of deferral<sup>xii</sup>. Portuguese special tax regime applies when all entities involved in reorganization are residents of Portugal or EU member states<sup>xiii</sup>. In order to satisfy all the conditions, the following plan can be considered: The acquired Chinese company creates a wholly-owned subsidiary in an EU member state to which target equity or assets are transferred, and the acquiring company then acquires the target assets or equity through the subsidiary. If successfully carried out, the plan will enable the acquired company's profits be taxed evenly over 10 years, relieving its tax burden. Since the acquisition cost of assets or

equity and selling price to Portuguese company are practically the same, no tax might be triggered in the transfer performed by the holding. For the acquiring company, the tax basis of assets or equity acquired being their fair value is also beneficial. However, due to the restriction of Chinese special tax regime that limits its application in this case to asset and equity transfer<sup>xiv</sup>, this plan is not applicable if merger is the intended operation. Further, tax authority may use general anti-abuse rules to deny the transfer to the holding company considering it as self-cancelling carried out solely for tax purposes and lacking economic reasons, resulting in the failure of the planning.

#### 1.2.2 Scenario B: A Chinese Company acquires a Portuguese Company

In merger and asset acquisition case, the general treatment is the same as discussed in the previous section (1.2.1), while equity acquisition is different due to the participation exemption of Portuguese tax law, which exempts capital gains arising from disposal of shares if certain conditions are met<sup>xv</sup>. While special tax regime only defers taxation and keeps tax basis as book value, the participation exemption is preferable as it exempts the capital gains and recognizes value change in tax basis.

In order to qualify for Portuguese special tax regime, the following plan can be considered to satisfy the regime's residence condition: The acquiring Chinese company establishes a holding company in EU member state and the holding performs the intended restructuring. The plan defers acquired company's tax burden, and from the acquiring Chinese company's perspective, its acquisition of target assets or equity through the holding company grants flexibility in the exit stage, as it can choose from disposal of participation in the holding or letting the holding perform



disposal. The tax results of the choice will be compared in the exit stage part.

## 2. Tax Considerations in Operating Activities

This part takes Portugal and China as operating states where activities (production, sales, services, etc.) take place. The fact to highlight is that neither Portugal nor China is tax haven, leading to the need to minimize tax payable so as to increase after tax profits – as required by the companies' duty of creating value for shareholders<sup>xvi</sup>.

### 2.1 Access to tax benefits

#### 2.1.1 Specified Incentives Concerning Company Nature or Sector

Chinese incentives: Enterprises engaging in agriculture, forestry, animal husbandry and fishery industry, or undertaking qualifying infrastructure facility, environment protection, water or energy saving projects and qualifying transfer of technologies are liable to lower taxation on income for a certain period of time<sup>xvii</sup>. SMEs and high-tech companies are subject to reduced income tax rate<sup>xviii</sup>. Portuguese incentives: Complete or partial tax exemption granted to shipping companies of merchant navy, entities managing package systems, sports, culture and leisure associations<sup>xix</sup>.

#### 2.1.2 Zone Specified Incentives:

Chinese incentives: In western regions a reduced rate of 15% is offered<sup>xx</sup>. However, only enterprises that mainly operate in certain industries in specific areas can qualify for the benefits<sup>xxi</sup>. For companies running business cross-regions, rate differences can bring further benefits as demonstrated by the following strategies:

Scenario 1: The headquarter is located in reduced rate area. The group – if necessary - can choose to operate in normal tax rate regions in the form of branch, as branches'

profits sum up to headquarters' and the total amount will be taxed at the reduced rate.

Scenario 2: The headquarter is located in normal rate areas. If group's business is entitled to reduced rate, running business in low-rate regions in form of subsidiary can be preferable as a subsidiary files tax return independently and is able to enjoy reduced rate. The group can further take advantage of rate difference by shifting profits generated in normal tax rate regions to the low rate regions with intra-group transactions. Nevertheless, the group should be aware of anti-abuse measures that empower tax authority to deny certain intra-group payments (e.g. management fees) or make adjustments (e.g. transfer pricing) when engaging in such activities.

Portuguese incentives: Madeira International Business Center (MIBC) - The entities licensed to operate in MIBC are taxed at reduced income tax rate of 5%, and industrial entities licensed as from 2015 can benefit from a 50% tax relief<sup>xxii</sup>.

### 2.1.3 Investment Specified Incentives

Portuguese incentives: A tax credit (10% to 25%) may be granted to eligible investment projects<sup>xxiii</sup>; Special Tax Regime to Support Investments (RFAI) grants tax credit to relevant investments made on fixed tangible and intangible assets<sup>xxiv</sup>.

Moreover, tax credit is available, under certain conditions, for R&D expenses<sup>xxv</sup>.

Chinese incentives: For enterprises invest in qualifying small-medium high-new technology enterprises, tax credit of 70% of the investment may be granted against the taxable income of the year when the two-year holding is completed.<sup>xxvi</sup>

## 2.2 Tax Deduction Considerations

Tax deduction rules are adjusted from the accounting rules to reflect the principles of

taxation (e.g. ability-to-pay)<sup>xxvii</sup> and government's intentions, namely super deduction that encourages certain behaviors and deduction limitations to discourage others<sup>xxviii</sup>.

### 2.2.1 Super Deduction

Chinese rules: Super deductions are allowed for R&D expenses incurred to develop new technology, products and techniques<sup>xxix</sup>. Portuguese rules: Tax credit is available, under certain conditions, for R&D expenses, combined with SMEs incentives<sup>xxx</sup>.

### 2.2.2 Limitations to Deduction

Chinese rules: Expenses allowed to be deducted till certain amount: employee welfare expenses, labor union expenses and education expenses for employees, entertainment expenses, advertising expenses and marketing expenses<sup>xxxi</sup>; Non-deductible: management fees, rentals and royalties paid between operational units within a company, and interest paid between operational units of a non-financial enterprise<sup>xxxii</sup>.

Portuguese rules: Generally, expenses of the such kind as fines or penalties are not deductible<sup>xxxiii</sup>. Special attention should be paid to regulations regarding payments to tax havens, as such non-deductible payments will even be taxed at 35% or 55%<sup>xxxiv</sup>.

The fact that non-deductible expenses cannot be used against taxable income leads to the necessity of planning for their full deduction. For expenses arising from intra-group activities, the group can sign cost sharing agreements approved by tax authorities to prevent certain subsidiary from incurring excessive non-deductible expenses. Regarding transactions with third party, a strategy that companies usually resort to is reclassification of expenses (e.g. consulting fee instead of advertising expense). Nevertheless, tax authorities may question the economic nature of the

reclassified transactions and recharacterize them as empowered by the general anti-abuse rules, which should be considered if engage in reclassification planning.

### 2.3 Tax Considerations concerning Value Chain Management

Multinational enterprises has the flexibility to carry out activities (purchasing, manufacturing, sales, R&D, etc.) globally, and they make geographic choice of where to perform certain operations based on tax implications as well<sup>xxxv</sup>. The differences in domestic tax laws give rise to tax planning, but anti-abuse rules also worth notice.

A common strategy used is the introduction of tax haven to the value chain<sup>xxxvi</sup>.

Consider the following example: A Chinese manufacturer plans to sell goods to Portugal, but the profits will be liable to high income tax, being it realized in China or Portugal. By introducing the tax haven, the tax burden could be significantly lowered:

In the manufacturing state (China), feeding processing method can be used, which assumes low risk and results in low value added. The tax haven purchases these manufactured goods at low price and sells to the final market with high margin. By properly designed distribution contracts, the value added in the final market (Portugal) is also low. The planning results in that most profits are transferred to tax haven, rather than being taxed in high tax jurisdictions where profits are actually generated.

Strategies of similar nature include provision of services to other group members by the element in tax haven, leading to expenses incurred in high tax burden jurisdictions and profits shifted to tax havens. Nonetheless, tax authorities have taken anti-abuse measures against such planning techniques, mainly through transfer pricing rules, controlled foreign company rules and regulations against payments to tax havens.

Transfer Pricing Rules: The possibility of profit manipulation stems from unfairly-transactions within a corporate group. Transfer pricing rules require that the price set by related parties to be the same as what would be agreed between unrelated entities; otherwise the tax authority is empowered to make adjustments. A corporate group exposed to Portuguese and Chinese rules should note the following: 1)Types of transactions covered: both rules cover financial transactions, commercial transactions, intra-group cost sharing and services<sup>xxxvii</sup>; 2)Definition of related parties: both rules determine the existence of special relation according to the degree of influence or control exerted, using percentage of shareholding as the parameter<sup>xxxviii</sup>.

Controlled Foreign Company Rules: The value chain planning that involves subsidiary created in tax haven<sup>xxxix</sup> can trigger controlled foreign company rules of the jurisdiction where the parent company<sup>xl</sup> is resident. The rules would compulsorily allocate subsidiary's not distributed profits to parent's taxable income. However, rules of both countries enable the parent company to waive such profit attribution as long as it can prove that the non-distribution of profits is out of substantial economic reasons<sup>xli</sup>, which can be satisfied by reinvesting the not distributed profits.

Moreover, Portuguese tax law determines that payments to tax havens are not deductible and even taxed at high rates<sup>xlii</sup>, and transactions with tax haven residents will be automatically deemed as transactions between related parties subject to transfer pricing rules<sup>xliii</sup>. Facing such rigid rules and possible severe penalties, any direct payment to tax haven should be considered twice as part of the planning, and any transactions with residents in blacklisted jurisdiction should be assessed carefully

according to arm length principle.

Due to the complexity of the anti-abuse regulations mentioned above and the consequent compliance burden, it is possible to ask the Portuguese tax authority for an advance ruling to clarify the tax treatment of a specific transaction or structure to eliminate any uncertainty, and in China, it also possible to enter into an advance pricing agreement with tax bureaus regarding transfer pricing issues.

### 3. Tax Considerations on Financing Issues

Since interest expenses incurred to support revenue generation are generally deductible with comparison to non-deductible dividends, debt financing can be fiscally preferable to equity. Based on this assumption, this part is devoted to tax issues – namely anti-abuse rules and international taxation – regarding debt financing.

#### 3.1 Deductibility and Rules of Interest Expenses Adjustments

Excessive interest expenses reported by companies will be adjusted by anti-abusive rules adopted by tax authorities. In China, interest expenses related to financial institutions can be deducted without assessment on term interest, while the rate on debt issued between non-financial enterprises will be adjusted according to that of loans of the same type and term provided by financial institutions<sup>xliv</sup>. Since debt financing activity falls in the scope of transfer pricing rules<sup>xlv</sup>, interest paid between related parties should be adjusted according to arm length principle. Further, when the ratio of debt to equity investment that an enterprise receives from related parties exceeds a specified value<sup>xlvi</sup>, the expenses related to debt in excess are non-deductible and are deemed as dividends<sup>xlvii</sup>. In this case, the tax authority may also examine the

nature of capital structure reported by the company. In Portugal, interest expenses can be deducted up to a predefined value<sup>xlvi</sup> and the non-deductible part can be carried forward<sup>xlvi</sup>. Such expenses shall be adjusted according to arm length principle too.

### 3.2 International Taxation Issues: Withholding tax, treaties and conventions

Chinese law determines that non-resident's interest income arising within territory to be taxed at 10%, while Portuguese rules tax such income at 25%. Despite these normal rates, double tax treaties generally grant different rates. The double tax treaty signed between Portugal and China determines the withholding tax rate on interest income of 10%, constituting an advantage in the case where a Chinese company finances a Portuguese resident with debt, as by applying the double tax treaty the withholding tax rate falls effectively from 25% to 10%.

Since withholding tax can add to borrower's tax burden, minimizing it would affect his cost of capital. In a corporate group setting, the use of holdings constitutes an opportunity to benefit from treaties. As tax havens generally have no treaties to eliminate double taxation or to exchange information with other countries, the creation of two holdings can be considered to benefit from lower withholding tax offered by treaties and lower taxation upon interest received in tax haven. The tax on interest income in the "treaty" holding will be offset by payment as expenses. Nevertheless, most tax treaties require that the treaty rate can solely be applied to the "beneficial owner" of the interest, meaning that the company entitled to treaty rate should not be conduit company created to benefit from treaties. Another tax risk that should be considered in financing arises from the disparities of transfer pricing rules

in different jurisdictions and the one-side adjustment to interest. Portuguese transfer pricing rules stipulate that in case of related parties corrections should be made to the taxable profit of part(ies) subject to IRC<sup>l</sup>, whereas Chinese rule does not clarify over this issue. An example of one-side adjustment could be that the interest expense of Portuguese resident is adjusted to lower value, leading to lower deduction before tax, but the Chinese tax authority does not adjust the interest income accordingly, meaning that interest received in China still faces high income tax.

#### 4. Tax Considerations on Distribution of Profits

Investment in shareholdings leads to ponderations on profit distribution's tax impacts. Cross-border profit distribution can trigger international taxation issues, and rule disparities and treaties leave space for tax planning but bring risks as well.

Concerning taxation upon receipt of dividend, Chinese resident's dividend income is taxed at rate of 25%<sup>li</sup>. Regarding economic double taxation relief mechanism, exemption is granted to dividends received by residents or non-resident's PE in China paid by residents<sup>lii</sup>, whereas in terms of dividends received from non-resident subsidiaries, the resident parent company is eligible for credits for its proportional share of taxes paid by subsidiaries abroad<sup>liii</sup>. In Portugal, resident's dividend income is taxed at rate of 21%. Regarding economic double taxation relief, Portuguese law adopts participation exemption regime which grants exemption to dividends received by residents in qualifying cases<sup>liv</sup>.

Regarding withholding on dividends, Chinese rules determine that dividends arising within territory paid to non-residents are liable to tax at rate of 10%. Portuguese rules



determine the same tax with rate of 25% which can be exempt if participation exemption applies.<sup>lv</sup> Notwithstanding domestic rules, EU Parent-Subsidiary Directive eliminates economic double taxation requiring exemption to dividend income at both parent and subsidiary level in qualifying cases, and double tax treaty between Portugal and China determines the withholding tax rate on dividend of 10%.

Regarding the abovementioned realities, tax-efficient profit distribution plans can be crafted. In the case of parent company being Chinese resident, 2 financial holdings can be created in tax haven (e.g. Hong Kong) and in EU member state that has signed favorable treaty with that tax haven (e.g. Netherlands). The profits that the Portuguese subsidiary intends to distribute will be transferred first through the EU holding then to the tax haven, facing no withholding and enjoying exemption upon receipt. Nevertheless, tax authorities may restrict such planning by including profits not distributed in parent's taxable income<sup>lvi</sup> and asking for proof of treaty's beneficial ownership. In the case of parent company being Portuguese resident, it is necessary to qualify for participation exemption concerning the tax upon income received, and the objective of minimizing withholding tax can be achieved by creating a holding company resident of EU member state (e.g. Luxemburg) with which China has signed a double tax treaty granting a further reduced withholding rate. Due to EU parent-subsidiary directive and prevalent participation exemption regime, such dividend will not face further taxation. Similar to the previous case, there is limitation to planning due to the risk of being considered as "treaty-shopping" by tax authorities.

## 5. Tax Considerations in Exit Stage

### 5.1 For Portuguese Investors that Entered Chinese Market and Intend to Exit:

In the case of direct entry, branch or subsidiary's cessation of business which involves transfer or deemed transfer of assets will be liable to tax upon realized capital gains in China. In merger or acquisition entry case, the capital gains realized from asset transfer are liable to Portuguese income tax, while in terms of disposal of shares the company can plan to qualify the participation exemptions by satisfying the requirements. The capital gains deemed as arising within Chinese territory<sup>lvii</sup> realized by non-residents can be liable to withholding tax in China, but according to the double tax treaty signed between Portugal and China, such capital gains realized from transfer of asset – with exception of immovable and PE's assets - should only be taxed in Portugal<sup>lviii</sup>. The treaty's clauses are clearly more favorable with comparison to normal cases where withholding tax would be levied on capital gains realized from certain transfers, which implies the importance for the company to qualify for the application of the treaty to lower its tax burden.

### 5.2 For Chinese Investors that Entered Portuguese Market and Intend to Exit:

In principal, the taxation faced by the Chinese investors or business runners that plan to business cessation or disposal are the same as what facing their Portuguese counterparties discussed above. Nevertheless, the following different tax implications should be noticed: In the case of disposal of shares by Chinese residents, any capital gains realized will be liable to Chinese income tax, due to the absence of participation exemption. Regarding such tax burden, the company should deploy a holding company to execute the merger or equity acquisition in the first place, so that the

disposal of shares performed by the holding may be liable to neither income nor withholding tax, as long as such disposal qualifies for participation exemption regime in the jurisdiction where the holding is resident – such exemption regime prevails in most EU member states, let alone the EU Parent-Subsidiary Directive that has the same effect. Nevertheless, Chinese tax authorities may apply CFC rules to attribute profits realized but not distributed by the holding to its parent Chinese company and tax them. Another point to note is the transfer of immovable property, as Portuguese tax law requires that the value of the property reported shall not be less than the valuation that served as the basis for assessment of municipal property transfer tax on the transfer for valuable consideration of property<sup>lix</sup>.

## Conclusion

With more commercial and investing activities to be expected between Portugal and China, this paper tries to answer the question of what are the tax factors to be considered for investors and entrepreneurs to elaborate better business plans, based on the tax implications of certain activities of 5 stages of business life cycle – entry, operating, financing, profit distribution and exit – derived from an in-depth analysis of tax laws and regulations. As lower tax burden can have a positive impact on return on capital as well as can facilitate the negotiation of business in certain cases – effects sought by business runners and investors, this paper further tries to figure out tax planning strategies that have the potential to achieve a lower tax burden, leading to better business results and satisfying directors and investors' objectives.

In the entry stage, direct and M&A scenarios are separately discussed as the rationale

behind such choice is affected more by factors other than tax. In direct entry case, a lower tax burden as a result from use of tax losses increases return on capital and contributes to better cash flow management. While Chinese company may be indifferent in legal form choices because of their same tax impact, a Portuguese company should establish P/L not exempt branch in loss-generating period, which is to be registered to subsidiary when it starts to generate profits. In comparison with other alternatives, this plan results in lowest global tax burden and avoids complicated juridical double taxation. In M&A case, lower tax burden facilitates the negotiation between counterparties, as target company may be unwilling to cooperate due to tax on transfer's proceeds. The target company can plan to qualify special tax regime or participation exemption to relieve its tax burden arising from transfer, which constitutes a better strategy than applying normal regime. The acquiring company should collaborate with the acquired company in planning so that it can benefit from high tax basis and tax losses and enjoy better exit stage tax outcome.

Regarding operating activities, lower tax burden contributes to higher net profits thus creates more value for shareholders. The company should try to access tax incentives granted by laws, pay attention to deduction limits and engage in value chain planning by exercising certain activities in properly chosen countries. Comparing to carrying out activities directly in Portugal or China where business profits are liable to high income tax, value chain planning enables shift of profits to tax havens where profits can be reinvested to finance the corporate group and to waive anti-abuse measures, lowering the otherwise high tax burden without planning.

Considering the financial structure from tax perspective, it could be concluded that debt financing is preferable to equity as only interest expenses are deductible, contributing to erosion to tax basis and thus creating higher value for shareholders. In the case of cross-border debt financing, the company can plan to benefit from more favorable double tax treaties to lower withholding tax, which constitutes a better strategy as debtor's cost of capital will be lower than without planning.

The tax impact – upon income received and withholding – on dividends will affect return on investments. Due to the absence of participation exemption, the Chinese income tax on dividends will discourage profit repatriation for MNEs. With proper planning - introduction of financial companies in Hong Kong and Netherlands, however, tax burden can be significantly lowered, eliminating the hurdle of profit distribution. In the case of parent company being Portuguese resident, it can qualify for participation exemption to eliminate tax upon receipt of dividends, and plan to access favorable double tax treaties to further lower withholding tax burden.

The options available in exit stage depend largely on the choices made in entry stage (e.g. legal form, merger or acquisition, etc.). Thus, the tax impact of exit stage should be considered in the first place if the investor is prepared to dispose sometime in the future, so that his business plan can be most tax efficient with highest return on capital. In the Chinese company acquiring Portuguese target case, several entry options lead to special tax treatment and same entry tax results, but among them the best strategy will be the acquiring company to create a holding in EU member state where participation exemption prevails, and to perform acquisition through the holding, so

that in the exit stage capital gains can be exempt.

As the abovementioned plans indicate, the use of holding company in tax havens or jurisdictions with favorable tax treaties and the insertion of intermediary transactional steps (e.g. transfers with holdings) are keys to the tax efficiency of planning. However, these planning techniques may catch the attention of local tax authorities who can apply anti-abuse rules (e.g. transfer pricing, CFC rules) to make adjustment to or even deny the planned transactions they consider without economic reasons and to deem holding as conduit company created solely for tax reasons, let alone the increasingly active global anti-abuse collaborations (e.g. BEPS plans proposed by OECD) that can further hamper the planning. Taking into account the uncertainty of whether such adjustments would be applied due to the blurred distinction between unacceptable avoidance and acceptable planning suggested by the Ramsay Principle<sup>lx</sup> and the negative impact of triggering adjustments – not only failure to lower tax but additional costs due to penalties, this paper points out that anti-abuse measures should always be taken into consideration in planning, and the best planning would be a balanced one – by letter in compliance with tax laws, and always having substantial economic reasons for its designed structures, transactions and other attributes as a defense of its legality. In order to avoid the complexity of compliance in the self-assessment case – for some companies such compliance burden and risk of incurring losses arising from special tax adjustments can outweigh the planning benefits, the tax payer can ask the Portuguese tax authority for an advance ruling or enter into an advance pricing agreement with tax bureau in China, so that the tax

treatment of a specific transaction or structure can be clarified, and the company can avoid the risk of going to court with tax authorities and its consequent huge costs.

Nonetheless, the research results and opinions presented by this paper have their limitations, especially in the long-term. The uncertainty lies in the perspective of macroeconomic environment leads to the fact that the fiscal policy of a jurisdiction – including tax policy as one of the most important means in resource allocation and redistribution – are to be adjusted accordingly from time to time, resulting in their volatility. In Portugal, the corporate income tax law has been increasingly volatile since the crisis, with in average 4 amendments made per year, including certain changes - conditions of participation exemption and the carry forward period of tax losses for example - that would affect significantly the result of planning. After the major amendment made in 2008, the Chinese Enterprise Income Tax Law has remained relatively stable. However, as a means to combat the increasingly serious problem of capital outflow and to close the loopholes being used by tax payers, the Chinese tax authority has been recently engaging actively in international anti-abuse collaborations, and updated special tax adjustment rules are expected to be released soon. Last but not least, the strategies suggested in this paper - such as the group structure to be considered for merger or acquisition purposes – take into account only the tax efficiency of the operation in order to simplify the analysis, focusing on the tax related factors as the only variant of planning, neglecting other important business aspects that may in practice affect the decision making of an economic agent, as well as the external factors other than tax regulations that will impact business or

investments, which can be demonstrated by Chinese regulations on foreign investments – even though Chinese tax law and treaties adopt capital-export neutrality<sup>lxi</sup>, which should result in Chinese capital’s indifference to invest domestically or abroad from tax perspective, other factors such as strict cross-border M&A supervision and foreign exchange control and could impact more economic agent’s investing viability.

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- <sup>v</sup> CIRC Artigo 69.º No.3 a)
- <sup>vi</sup> CIRC Artigo 54.º-A No.4
- <sup>vii</sup> Bulletin of the State Administration of Taxation [2010] No 1.
- <sup>viii</sup> He, Xu. 2012. “Corporate Income Tax Policies in Merger and Acquisition” in *Tax management in Capital Transactions with Example Analysis*. Beijing: China Taxation Publishing House.
- <sup>ix</sup> Caishui [2009] No.59 Art.4
- <sup>x</sup> Shanghai National Accounting Institution. 2010. “Tax Planning in Merger and Acquisition” in *Mergers and Acquisitions*. Beijing: Economic Science Press.
- <sup>xi</sup> Caishui [2009] No.59 Art.7
- <sup>xii</sup> Caishui [2009] No.59 Art.8
- <sup>xiii</sup> CIRC Artigo 73.º No.7
- <sup>xiv</sup> *Ibid.*
- <sup>xv</sup> CIRC Artigo 51.º-C. Minimum qualifying shareholding requirements: holding period not inferior to 1 year, percentage of shareholding not inferior to 10%
- <sup>xvi</sup> Underhill, William. 2013.” Tax and directors’ fiduciary duties.” *Tax Journal*, edition 27 of September 2013
- <sup>xvii</sup> Enterprise Income Tax Law Art. 27
- <sup>xviii</sup> *Ibid.* Art.28
- <sup>xix</sup> Estatuto dos Benefícios Fiscais, Capítulo VIII.
- <sup>xx</sup> Bulletin of the State Administration of Taxation [2015] No.14
- <sup>xxi</sup> Detailed information related to the operating industries to which tax incentives are granted refers to Guo Fa No.15 (2014)
- <sup>xxii</sup> PwC Portugal. 2016. *Tax benefits – companies resident for tax purposes in Portugal*.
- <sup>xxiii</sup> *Ibid.*
- <sup>xxiv</sup> *Ibid.*
- <sup>xxv</sup> *Ibid.*
- <sup>xxvi</sup> Implementation Regulations of the Corporate Income Tax Law Art.97
- <sup>xxvii</sup> Lei, Liu. 2008. “Basic Assumptions Difference” in *Analysis of Differences between Corporate*



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*Income Taxation and Accounting Standards and Adjustments*. Beijing: China Financial and Economic Publishing House.

<sup>xxviii</sup> Correia, Miguel. 2010. "The Corporation Income Tax and Corporate Behavioral Control." In *The Taxation of Corporate Groups Under a Corporate Income Tax*. Ann Arbor: ProQuest LLC.

<sup>xxix</sup> Enterprise Income Tax Law Art. 30 A 50% super deduction is allowable in addition to the actual expense deduction in case of not capitalized expenses; if capitalized as intangible assets, cost bases of the intangible assets equal to 150% of actual costs are allowable for amortization purposes.

<sup>xxx</sup> Pwc Portugal. 2016. *Tax benefits – companies resident for tax purposes in Portugal*. Available credit value: (i)32.5% of expenses borne during the tax year; (ii)50% of the surplus of expenses borne in the tax year over the average of the two previous tax years, capped at € 1,500,000; percentages increased by 15% for SMEs.

<sup>xxxi</sup> Implementation Regulations of the Corporate Income Tax Law Art 40 - 44

<sup>xxxii</sup> Implementation Regulations of the Corporate Income Tax Law Art.49

<sup>xxxiii</sup> CIRC Artigo 23.º-A

<sup>xxxiv</sup> CIRC Artigo 88.º, No,8

<sup>xxxv</sup> Bei, Liang. 2011. "Tax Planning of Multinational Enterprises" in *International Tax Planning*. Beijing: University of International Business and Economics Publisher.

<sup>xxxvi</sup> Bei, Liang. 2011. "Tax Planning in Manufacturing and Sales" in *International Tax Planning*. Beijing: University of International Business and Economics Publisher.

<sup>xxxvii</sup> Portuguese rules regarding transaction types sees CIRC Artigo 63.º -1. Chinese rules regarding the same issue sees Bulletin of the State Administration of Taxation [2016] No.42.

<sup>xxxviii</sup> Portuguese rules regarding shareholding percentage qualifying for control sees CIRC Artigo 63.º -4. Chinese rules regarding the same issue sees Bulletin of the State Administration of Taxation [2016] No.42.

<sup>xxxix</sup> Tax rate lower than 60% of IRC according to Portuguese rules, see CIRC Artigo 66.º ; effective tax rate lower than 12.5% according to Chinese rules, see Implementation Regulations of the Corporate Income Tax Law Art.118..

<sup>xl</sup> In terms of percentage of holding that trigger CFC rules, Portuguese rules see CIRC Artigo 66.º., and Chinese rules on same issue refer to Implementation Regulations of the Corporate Income Tax Law Art.117.

<sup>xli</sup> Guo Shi Fa [2009] No. 2 Art 84

<sup>xlii</sup> CIRC Artigo 88.º -8

<sup>xliii</sup> CIRC Artigo 63.º -4h)

<sup>xliv</sup> Implementation Regulations of the Corporate Income Tax Law Art.38

<sup>xlv</sup> Bulletin of the State Administration of Taxation [2016] No.42.

<sup>xlvi</sup> Cai Shui [2008] No.121: D/E 5:1 for non-financial enterprises, or 2:1 for financial institutions

<sup>xlvii</sup> Enterprise Income Tax Law Art.46

<sup>xlviii</sup> CIRC Artigo 67.º -1

<sup>xlix</sup> CIRC Artigo 67.º -2 carry forward period of 5 years

<sup>l</sup> CIRC Artigo 63.º -11

<sup>li</sup> Enterprise Income Tax Law Art.6

<sup>lii</sup> Enterprise Income Tax Law Art.26

<sup>liii</sup> Enterprise Income Tax Law Art.24

<sup>liv</sup> CIRC Artigo 51.º

<sup>lv</sup> CIRC Artigo 51.º

<sup>lvi</sup> Enterprise Income Tax Law Art. 45

<sup>lvii</sup> Implementation Regulations of the Corporate Income Tax Law Art. 7

<sup>lviii</sup> *Idem*, Art. 13

<sup>lix</sup> CIRC Artigo 64.º - 1

<sup>lx</sup> McLaughlin, Mark.2000. "The Ramsay Principle". *Tax Articles – General*.

<sup>lxi</sup> Doernberg, Richard L.2016. "Economics in Juridical Double Taxation" in *International Taxation in a Nutshell*. St. Paul: West Academic Publishing.