PORTUGUESE TAXATION OF DISTRIBUTIONS FROM TRUST CAPITAL: A CRITICAL ASSESSMENT

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INTRODUCTION

As a general rule, trusts are alien to Portuguese law, with the exception of the legal framework for the Madeira Free Trade Zone. Foreign trusts are not recognized in Portugal, which may pose practical problems for family and succession planning when individuals who lived abroad come to reside in Portugal and become treated as tax residents. The attractiveness of Portugal has resulted in a substantial number of wealthy immigrants. For these individuals, the taxation of trust distributions has become a significant part of tax planning, both in the pre- and post-immigration stages.

The 2014 reform of the Personal Income Tax ("P.I.T.") Code introduced certain provisions that specifically address "fiduciary structures." The new provisions address two separate classes of payments related to a fiduciary structure. The first class involves amounts paid or made available to the taxpayer by a fiduciary structure. The second class involves amounts received by the taxpayer who formed the fiduciary structure as a result of its liquidation, unwinding, or termination. Since virtually none of the trusts established by new immigrants have been formed under the laws of Portugal[1] and inasmuch as none are deemed to be tax-resident in Portugal under Portuguese tax legislation, the income generated abroad by the trusts generally is not taxed in Portugal, except in the hands of the beneficiary who is tax-resident in Portugal or if controlled foreign company rules apply. The receipt of the trust distribution triggers tax issues for the beneficiary who is deemed or registered as tax-resident in Portugal.

The first class of distributions qualifies as investment income ("*Categoria E*" as named in the law) and is subject to tax in the hands of a Portuguese tax resident. The second class is subject to tax on a capital gain basis (under "*Categoria G*" rules), meaning a taxpayer who, as written in the law, "constituted the structure" is taxed only on the gain when the value received upon the liquidation, unwinding, or termination exceeds the basis in assets transferred to the fiduciary structure during its existence. As such, note that amounts received by a non-settlor beneficiary as part of a liquidation, unwinding, or termination distribution are outside the scope of P.I.T.

All trust distributions are allocated between the two classes above. Hence, they are framed as *Categoria E* (investment income) or *Categoria G* (capital gains). It follows that all distributions arising out of the capital of the trust are prima facie taxable in full as a Class 1 distribution, therefore following *Categoria E* rules. Whether this literal approach is correct is open to question as, in the author's view, it lacks a

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1 See below at note 3 relating to the fact that Portugal has not signed the Hague Convention on the Law Applicable to Trusts and Their Recognition.

sound legal basis under the general principles of Portuguese tax law. In addition, solid technical arguments support the view that a distribution made from the capital of a trust should be deemed outside the scope of Portuguese P.I.T. when made to a non-settlor of the trust or that the capital gains rules should apply when the person receiving the distribution is a settlor of the trust.

OVERVIEW OF DISTRIBUTIONS FROM TRUSTS

The Commentary to Article 1 of the O.E.C.D. Model Convention on Estates and Inheritances and on Gifts states that a trust exists when (i) one person, the "trustee," who is the "legal" owner of property, (ii) holds the property under a legally enforceable obligation (iii) to use it for the benefit of another person or group of persons, the "beneficiary" or "beneficiaries," (iv) who are the "beneficial" owners of the property.

Hence, a trust holds and distributes funds following the terms of the trust deed, which sets forth the purpose of the trust and identifies the beneficiaries. Assets are transferred to the trust by a settlor, with the purpose of designating the management of the assets to a third party and the enjoyment of the trust to the beneficiaries. The trust assets may produce income, which is realized for the benefit of the beneficiaries, or gain, which typically is an accretion to capital and is treated separately from the income. The trust deed generally provides for how the trust income is retained or distributed and how the capital may be held as an endowment or distributed to capital beneficiaries which may differ from income beneficiaries.

Consequently, trust distributions can be divided into two separate baskets. The first basket relates to distributions of the income generated by the trust from the investment of its capital into income producing assets. The second basket relates to distributions of capital – the original capital contributed increased by the net gains from the sale of the assets. Conceptually, capital distributions should not be considered to be income. Rather, they should be viewed as the current value of the capital contributed to the trust, as it may have appreciated over time. Viewed this way, a capital distribution to a person who is not a settlor of the trust could be viewed as a form of gift.

The result should not change even when tax transparency is applied. Income arising at the level of the trust but flowing to the beneficiaries is usually subject to tax in the hands of a beneficiary under income tax provisions in the beneficiary's country of residence. In the off chance that the jurisdiction of residence for the trust imposes a general income on capital gains, typically, the trust pays that tax. Transfers of capital to the trust may be subject to a gift tax[2] payable by the settlor when the trust is not considered to be transparent. Transfers of capital from the trust are, as a general rule, not taxable. If the jurisdiction of residence for the trust imposes a general income tax, capital gains may be imposed when a capital asset owned by the trust is sold at a gain.

INCOME ARISING FROM TRUSTS

Trust law has its origins in English law, and trusts are widespread in common law jurisdictions. Portugal is a civil law jurisdiction that does not recognize trusts.

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2 See, *e.g.*, Pierre Gillioz and Nicole Fragnière Meyer, "Trusts and Taxation in Switzerland," *IBFD Bulletin for International Taxation* 69, no. 4/5 para. 2.3 (2015).

Portugal is not a signatory to the Hague Convention on the Law Applicable to Trusts and Their Recognition.[3] However, trusts have generated tax issues in Portugal where former nonresidents have migrated to Portugal and retained their status as beneficiaries of foreign trusts.

From the viewpoint of the Portuguese media and, to some extent, the tax authority, the use of trusts is mainly associated with tax evasion and tax avoidance schemes. With the exception of the Portuguese income tax treaties with the U.S. and Canada, neither Portuguese income tax treaties in general nor the O.E.C.D. Model Tax Convention make reference to the allocation of taxing rights in the case of a trust that is tax-resident in a treaty partner jurisdiction. Hence, income tax treaties are usually not useful when individuals that are newly arrived Portuguese residents are settlors or beneficiaries of trusts.[4]

"Portuguese legislation is not entirely up to speed when compared with international practices and standards."

While treaties are silent as to the tax treatment of trusts, the 2014 revisions to the P.I.T. Code specifically addresses fiduciary structures. As mentioned above, the provisions covering the tax treatment of trusts appear straightforward and cover two situations, *viz.*¸ Class 1, involving any amounts paid or made available by the trust, which the author construes as being distributions of income; and Class 2, involving distributions that are incident to the liquidation, unwinding, or termination of a trust. Nonetheless, many practical problems exist, and certain unexpected complications may rise, partly because the legislation does not reflect standard practices followed in jurisdictions where trusts generally are formed and administered. This is understandable in a civil law context where trusts are not commonly used in estate

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3 For an historical overview of the recognition of trusts in Portugal and the tax landscape surrounding a foreign trust, see Francisco de Sousa da Câmara "The Taxation of Trusts in Portugal," *IBFD European Taxation* 57, no. 11 (2017). Article 2, Chapter 1 of the Hague Convention on the Law Applicable to Trusts and Their Recognition states that "for the purposes of the Convention, the term 'trust' refers to the legal relationships created – inter vivos or in death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose."

4 As can be read in "Trusts and the Fundamental Freedoms – The Exit Tax Regime in Trustees of the P Panayi (Case C-646/15)," *IBFD European Taxation* 58, no. 6 (2018):

> The Commentary on the OECD Model mentions trusts in connection with the possibility to claim treaty entitlement, which is dependent on meeting the requirements under the personal scope of a particular treaty, *i.e.* whether a legal vehicle – a trust – can be considered a person that is resident in one or both of the contracting state(s). The Commentary mentions trusts in the context of collective investment vehicles (CIVs), and indicates that CIVs could be considered companies or trusts, simple contractual arrangements or a form of joint ownership. In this sense, trusts are compared to CIVs in terms of their nature. The Commentary states that, 'whether a CIV is a 'resident' of a Contracting State depends not on its legal form (as long as it qualifies as a person) but on its tax treatment in the State in which it is established.' This means that the qualification of a trust, as either a transparent or non-transparent entity, is dependent on its nature under the domestic tax law of the contracting state. The Commentary implies that the domestic tax regime should be decisive.

planning.[5] In this respect, Portuguese legislation is not entirely up to speed when compared with international practices and standards.

With respect to typical distributions from a trust, the P.I.T. Code casts a broad jurisdictional net, providing that all amounts paid or made available to the taxpayer by fiduciary structures are taxed. Under the plain meaning of the statute, all payments received from a trust by a Portuguese resident are subject to tax in Portugal as investment income (*Categoria E*).

This interpretation can lead to inconsistent tax treatment triggered by inconsequential differences in facts. This can be illustrated as follows:

- A liquidation distribution made to a non-settlor is outside the scope of P.I.T.[6] It is not taxed.
- If the liquidation distribution is made to the settlor, the distribution is subject to tax on a capital gains basis. This means the tax base is the amount by which the value received exceeds the cost basis in assets transferred to the trust.
- If the same asset is distributed to a beneficiary in an ordinary trust distribution, the entire distribution would be taxed at the standard rate of 28%, or at 35% if the trust is located in a tax advantaged jurisdiction (within the so-called blacklist published by the Portuguese government).
- Were a nonresident individual to transfer the same asset to a Portuguese resident as a gift, the gift would be outside the scope of P.I.T. No gift or inheritance tax would be due as Portugal does not have a formal gift tax regime. [7]

In sum, a literal interpretation of the statute contains logical flaws, as no single baseline tax is relied on to determine abusive situations, taxable transactions, and gifts that are completely exempt from income tax. The literal interpretation is inconsistent with fundamental principles of Portuguese tax law and the Portuguese Constitution.

TAX TREATMENT OF DISTRIBUTIONS FROM THE CAPITAL OF A TRUST

It can be argued that the guidelines incident to the 2014 P.I.T. reform suggest that income distribution from a trust should be taxed in a manner that is consistent with investment income and other similar gains. The P.I.T. Code defines the term "income" as an amount received that results in an increase in the purchasing power and net worth of the taxpayer (rendimento-acréscimo). Gifts are excluded from giving rise to taxable income.

The Portuguese Constitution contains a principle of "taxation following the ability to pay." It follows that the purpose of the P.I.T. is to tax income, not wealth. Hence,

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5 *E.g.*, in the case of discretionary trusts, see "Dutch Tax Treatment of Discretionary Trusts," *ITSG Global Tax Journa*l, 1, no. 3 (2018).

6 Article 12.8 of the P.I.T. Code.

7 However, Portuguese Stamp Duty may be imposed if the operation is deemed within its territorial scope of application. In the case of free transfers, the Stamp Duty rate is 10% and can amount to 10.8% in the case of free transfers of real estate.

distributions from the capital of a trust should not be taxed, as there is no accretion to wealth when all that is received is capital over which the beneficiary held a beneficial interest prior to receipt. In addition, the P.I.T. Code adopts a schedular approach to the imposition of tax. Under this approach, a particular type of income is taxable only if it falls within a specific schedule of taxable income. In general, receipt of capital is not covered by any schedule. The fact that the capital is held in a trust should not be a material factor to prevent application of the general rule.

Distributions of Capital to a Settlor

In principle, distributions of capital to a settlor do not represent a net increase in the settlor's ability to pay, since it is essentially a return of capital previously transferred to the trust. At the same time, and for the same reason, it does not increase the settlor's net worth and purchasing power. In this sense, the receipt of a distribution of capital to the person who settled the trust and contributed capital assets to the trust is not an income event. It was the settlor's capital before it went into the trust, the settlor held a beneficial interest while the capital was an asset of the trust, and it remained the settlor's capital when returned in the form of a contribution.

Nonetheless, in the hard, cold light of day, the law is what the law is; and a capital distribution not incident to the liquidation, unwinding, or termination of a trust potentially is taxable income. If so, how should it be categorized for the schedular tax system in Portugal?

Investment Income?

Investment income may be thought of as income arising from figures akin to civil fruits under Portuguese law, meaning the amounts that are produced by an asset and to which an individual is entitled to under some sort of a legal relationship.[8] In other words, the "fruit" that grows from an investment "tree."

Investment income may be interpreted as any economic advantage acquired directly or indirectly, under whatever of name or designation, in cash or in specie, from patrimonial elements, assets, rights, or juridical situations of a movable nature, including their modification, transmission, or termination whenever not subject to tax in a different category. Article 5.1 of the P.I.T. Code is meant to tax the fact that an individual receives the fruits but not the income that arises from the disposal of the tree.

Therefore, interpreting a return of trust capital to a settlor as falling within a legal provision dealing with investment income is inconsistent with the type of income that is meant to be taxed as investment income for P.I.T. purposes. A distribution of trust capital is not akin to fruit growing on a tree each summer; it is not akin to civil fruit. The taking of the fruit does not diminish the value of the tree, whilst a distribution of capital is, in fact, akin to taking down a major limb and diminishes the growth potential of the trust.

From a technical perspective, taking into account the income that is subject to tax under the Portuguese P.I.T. system, a distribution of capital may not represent an accretion of taxable income in the hands of the beneficiary. Or, even if it does, it is only on a capital gain basis. Taxation following the investment income rules would not take into account the gain that actually may rise: The rules would deem the full

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8 See Article 212 of the Portuguese Civil Code.

amount received by the beneficiary under a capital distribution to be subject to tax, irrespective the actual gain that can be raised in the hands of the beneficiary. In this light, if a capital distribution is interpreted as investment income in the hands of the Portuguese tax-resident beneficiary, the tax imposed would not follow the actual net gain; it would outweigh the actual "income" received. Hence, such an approach is inconsistent with the constitutional principle of taxation following the ability to pay and other general taxation principles of Portuguese law.

"When the P.I.T. Code imposes tax on 'amounts paid or made available by fiduciary structures,' the statute was intended to address income distributions and not distributions of capital."

Other Taxable Income?

Having established that an eventual net capital gain is income but not investment income, the question remains whether any other provision in the P.I.T. Code subjects that income to tax. Income arising from the disposal of assets is potentially taxed under the category of income pertaining to other asset increases (*Categoria G*), under capital gains (*mais-valias*). Therefore, it is logical for distributions arising from the liquidation, unwinding, or termination of a trust to be outside the scope of P.I.T. when made to a non-settlor or subject to tax as a capital gain if made to a settlor. The same line of reasoning should be applicable to distributions of capital that is not incident to a liquidation or similar event. The positive increase in fair market value may give rise to a taxable gain.

The tax treatment of a capital distribution of a trust should not be materially different from the treatment of a distribution of capital from a company to its shareholders. When a company reduces its share capital, Portuguese tax law treats the capital distribution to the shareholders as return of capital, not as taxable income. It is a simple return of the amount previously invested. It is not income in the sense of *rendimento-acréscimo*, the relevant income for P.I.T. purposes.

In any event, Portuguese law contains a principle under which income that is not of a kind that is addressed under the law should be deemed to be outside the scope of taxation. Following this line of reasoning, the law does not clearly foresee the taxation of the capital gain arising from a distribution of capital to a settlor of a trust as long as the trust is not connected to the individual's business activity. Arguably, the capital distribution is outside the scope of Portuguese P.I.T.

Distributions of Capital to a Non-Settlor

Considering all that has been discussed above, it is clear that, when the P.I.T. Code imposes tax on "amounts paid or made available by fiduciary structures," the statute was intended to address income distributions and not distributions of capital. Hence, when looking at a distribution out of the capital of a trust, the transaction is akin to a gift in the hands of the beneficiary, which is not subject to income tax. This conclusion is supported by the treatment of distributions to non-settlors that are incident to a liquidation, unwinding, or termination of a trust. Those distributions are not taxed under the P.I.T. Code. No policy reason exists to provide different treatment for a distribution of trust capital to a non-settlor that is not incident to the liquidation, unwinding, or termination of a trust.

CONCLUSION

Although untested, solid arguments support the view that distributions of trust capital to the settlor of a trust should be seen as outside the scope of the Portuguese

P.I.T. Code. Only income under P.I.T. concepts should be taxed. Distributions to non-settlors are essentially akin to gifts, which are outside the scope of income taxation in Portugal.

When dealing with a return of trust capital and a distribution arising from the liquidation or termination of the trust, a capital distribution made to the settlor should be construed as a "return" of the capital previously contributed to the trust. No income or gain is generated as long as the value of the distribution does not exceed the basis in assets previously contributed. In addition, a capital distribution made to a person who is not the settlor of the trust should be treated as a gift.