

NHR – TAXATION OF RESULTS

ALL FINANCE MATTERS

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Understanding Informação Vinculativa (Binding Information): NHR – Taxation of results attributed to partners by S-Corporation located in the USA_IV 23980. RNH – Tributação de resultados imputados a sócio por S-Corporation localizada nos EUA

What is Informação Vinculativa (Binding Information)?

Binding Information, refers to an official response issued by tax authorities in Portugal, addressing specific queries from taxpayers regarding the interpretation or application of tax laws in particular situations. These rulings hold legal authority and must be followed by both the taxpayer and the tax authority, provided that the circumstances remain unchanged.

Importance of Binding Information:

Formality: They provide an official and authoritative interpretation of tax legislation.

Obligation: Both the tax authority and the taxpayer must adhere to the ruling, provided the facts presented remain unchanged.

Legal Certainty: Binding rulings offer taxpayers clarity and legal certainty regarding their tax obligations. By outlining how tax laws apply to their specific circumstances, taxpayers can plan and conduct their financial activities with confidence.

Procedure: Taxpayers must formally request binding information by detailing their specific circumstances for accurate analysis.

Facilitating Planning: Provides confidence for taxpayers in planning their financial activities.

Avoiding Disputes: Ensures compliance with tax laws, thereby reducing potential disputes with tax authorities.

Ensuring Fairness: Promotes fairness in tax treatment by providing consistent interpretations of tax laws.

Example Scenario:

Legislation: Personal Income Tax Code

Article/Item: : Article 81 – Elimination of international double taxation

Subject: NHR – Taxation of results attributed to partners by S-Corporation located in the USA

Details of the Scenario:

Request for Binding Information: The applicant, a resident of the United States of America, wishes to request binding information regarding the tax framework applicable to them concerning the distribution of profits from a company located in the United States of America.

For this purpose, they clarify the following:

- The applicant is a dual citizen of the United States and Portugal, with tax residency in the United States of America.

- They are considering relocating their residency to Portugal in the short term and, subsequently, enrolling in the Non-Habitual Resident ("NHR") tax regime, as they have not been tax residents in Portugal for the last 5 years.

- They hold shares in the capital of XXX, a company domiciled and resident in the United States of America, structured as an S-Corporation (hereinafter referred to as "S-Corp" or "Company"), an entity similar to a partnership established and governed by the laws of the United States, classified as a transparent entity in that country.

- In this context, in that jurisdiction, the results reported by the S-Corp are attributed to its partner as professional and business income, taxed at progressive rates under U.S. corporate income tax. In other words, the results reported by the S-Corp are allocated to its owner in proportion to their shareholding, and are taxed in the sphere of the latter as professional and business income, regardless of their actual distribution to the partners.

- With the possible establishment of the applicant's tax residency in Portugal in the short term, and considering that the company in question does not meet the criteria set forth in Article 6 of the Corporate Income Tax Code to be considered transparent for tax purposes in Portugal, there may be a conflict in the taxation of the applicant's income, given the involvement of two states (i.e., the source state of the income related to the mentioned shareholding – the United States of America – and the state of residence of the taxpayer – Portugal).

- It is deemed essential to confirm that, under national tax legislation, the distribution of profits from the S-Corp to the applicant, a citizen seeking to establish tax residency in Portugal and benefit from the Non-Habitual Resident ("NHR") tax regime, will be exempt from taxation during the duration of this regime in their sphere.

- They thus understand that, in Portugal, a tax event will only occur upon the possible distribution of income arising from an actual distribution of profits from the Company, which, under Portuguese law, would qualify as capital income, namely, dividends.

- In this regard, it is relevant to note that the Tax Authority (AT) has already issued a statement on a situation similar to yours, as detailed in doctrinal note No. 2360/2016, with an agreement from the General Director, dated December 20, 2017, where the AT concludes that the tax transparency regime applied to partnerships under U.S. law cannot be applied in Portugal in the same manner as the tax transparency under Portuguese legislation.

- Lastly, it is noted that the AT, in the aforementioned doctrinal note,

considers that these incomes should qualify, in domestic terms, as dividends. However, as noted by the AT, "this type of entity (LLC) is covered by the exclusion provided for in No. 3 of the Protocol to the DTA established between Portugal and the USA, and, as such, these incomes are not treated, for purposes of assigning taxing rights, in the terms defined for 'dividends', but rather by the provisions of Article 24 of the DTA [Other incomes], which implies shared taxing rights, i.e., both States may tax these incomes."

- It also refers that the Administrative Arbitration Centre ("CAAD"), in Process No. 684/2020-T, dated March 28, 2022, when analyzing the terms of the saving clause between Portugal and the United States of America, judged that the taxpayer (a national citizen of the United States of America - like the Applicant - who benefits from the NHR regime - as will apply in the Applicant's case) could be subject to taxation in the United States of America, even in specific cases where taxing rights are granted solely to the State of residence (i.e., Portugal), thus considering that the condition set to apply the exemption method in Portugal on their income was fulfilled. In this regard, the CAAD understood that "the Protocol that is part of the Convention with the United States of America reserves the ability of this State to tax its nationals (citizens) 'as if the Convention had not entered into force', i.e., to tax their income on a worldwide basis according to its domestic law, commonly referred to as the 'saving clause' - see Article 1, letter b) of the aforementioned Protocol."

- Given that the applicant, should they change their tax residency to Portugal, will enroll in the Non-Habitual Resident ("NHR") tax regime, they request that:

a) the incomes be qualified as other incomes under the Convention to avoid Double Taxation ("DTA") and that it establishes shared taxing rights between the two States (Portugal and the United States of America);

b) it be confirmed that they can benefit from the application of the exemption method provided for in Article 81 of the IRS Code, with the distribution of profits being exempt from taxation in Portugal, considering that the exemption method will apply to these incomes in the applicant's sphere (naturally, only during the duration of this regime), as their taxation is provided for in the State of source under the Convention to avoid Double Taxation with the United States of America.

Response and Guidance:

1. According to a query to the AT's computer system, it is confirmed that the applicant was in the situation of being a resident abroad at the time of submitting the request for binding information.

2. Regarding the type of company in question, it is clarified, beforehand,

that business activity in the USA can take on different types of structures, each corresponding to a specific tax regime. One of these structures is the "S-Corporation," which, like LLCs (Limited Liability Company), limits the liability of the partners to their shareholding. These companies are required to comply with certain requirements and have a specific tax regime (distinct from the tax regime applicable to "Corporations," as these are independently taxed entities that submit their annual income tax return and are subject to taxes on profits).

3. "S-Corporations" are companies that cannot have more than 100 shareholders, all of whom must be American citizens or permanent residents in the USA. The profits generated are allocated to the shareholders in proportion to each one's interest in the business, similar to "partnerships" (with the advantage that their personal assets are not liable for any debts or liabilities).

4. The taxation of income occurs as in "partnerships" through the so-called "pass-through taxation," meaning that profits and losses are passed on to the shareholders and taxed or deducted directly on their tax return, avoiding double taxation on profits.

5. Considering that the applicant intends to reside in Portuguese territory, they will be subject to income tax (IRS) on a personal or subjective basis, which means that the IRS applies to all their income, including that earned outside this territory.

6. If the applicant meets all the requirements for the application of the non-habitual resident tax regime, repealed by Law No. 82/2023, of December 29 (see the transitional regime provided in paragraphs 3 to 5 of Article 236 of this Law), and assuming that the regime is recognized, the special regime for this type of residents will be applicable, particularly regarding the exemption method provided in paragraphs 4 and 5 of Article 81 of the IRS Code (CIRS), in its previous wording.

7. Regarding the classification of income (taxable matter attributed) earned as a "partner" in a company qualified as an "S-Corporation" resident in the USA, as previously mentioned, it is subject in that State to a similar transparency tax regime, as stipulated in the IRC Code and the IRS Code, where the results (taxable matter) are not taxed at the corporate level but are taxed exclusively at the individual level due to their status as a partner.

8. However, this does not mean that such a tax transparency regime can, in comparative law terms, be equated to the tax transparency regime in the Portuguese legal system, namely that provided for in Article 6 of the IRC Code.

9. In fact, the monetary allocation of the taxable matter of the "S-Corporation" to the respective partner residing in Portugal constitutes capital income qualified as profit, according to Article 5 of the CIRS and subject to a separate taxation at a special rate of 28%, as stipulated in paragraph d) of Article 72 of the IRS Code, without prejudice to the option for its inclusion, as provided in paragraph 13 of the same article.

10. According to the Convention for the Avoidance of Double Taxation (CDT) between Portugal and the USA, and given that it involves an entity subject in that State to a transparency tax regime, it will be covered by the exclusion provided in paragraph 3 of the Protocol annexed to this CDT. Consequently, the income earned by the respective non-resident shareholders in the USA does not qualify under the CDT as dividends, and the provisions of Article 24 (Other Income) apply to them.

11. This Article 24 grants cumulative tax jurisdiction to both States (Source State and Residence State), meaning that the income in question meets the condition set out in paragraph a) of paragraph 5 of Article 81 of the IRS Code, and thus the exemption method provided in that provision applies, provided that the applicant meets all the conditions to benefit from the previous non-habitual residents regime and enrolls under this regime (see paragraphs 3 to 5 of Article 236 of Law No. 82/2023, of December 29 (State Budget for 2024)).

12. Notwithstanding the above, if desired, the taxpayer may opt for the tax credit method under paragraph 8 of Article 81 of the IRS Code.

Conclusion:

Binding information is crucial as it offers official and precise guidance on specific tax issues. In this scenario, the applicant requested clarification regarding the tax treatment of profits from an S-Corporation while considering enrollment in the Non-Habitual Resident (NHR) regime in Portugal.

In conclusion, the income attributed to a shareholder from an S-Corporation is classified as capital income under Portuguese law and is subject to separate taxation. However, if the applicant qualifies for the NHR regime, this income may be exempt from taxation in Portugal, given it has already been taxed in the U.S. The taxpayer can further eliminate double taxation by opting for the exemption method outlined in Article 81 of the IRS Code. This binding information ensures that taxpayers receive accurate guidance, facilitating compliance with tax regulations and helping avoid potential penalties or errors in tax declarations.



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"YOU MUST PAY TAXES, BUT THERE'S NO LAW THAT SAYS YOU NEED TO LEAVE A TIP."