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Retirement in Europe

the tax aspect

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International Tax Planning Association

Retirement in Europe: the tax aspect

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1. Introduction

The option of retirement in Portugal is quite appealing, and since the beginning of the eighties, Portugal has been a destination for the retirement of many northern European citizens, mainly because of the weather and the mixture of the vibrant and sophisticated European lifestyle of the main cities together with the traditional lifestyle of the rural regions and the beautiful coastline of the country. However, the sun, the sea and golf are not everything, and Portugal is quite appealing when it comes to individual taxation, especially since the 2004 Property Reform, when inheritance tax was totally abolished between parents and sons and between spouses. Since this reform, there has been an increase in investment in property in Portugal.

1.1. *Tax system*

The tax regime presently in force in Portugal was adopted in the mid-80's and conforms with the various directives and guidelines of the European Community. The Portuguese tax system, like any other European tax system, includes both indirect and direct taxation. There are taxes on the worldwide income of companies and individuals, as well as value added tax (VAT) (pursuant to the 6th European Directive, and basically identical to that of other European countries), property transfer tax (IMT), stamp duty, and municipal property tax (IMI), and various minor indirect taxes on consumption.

1.2. *Concept of residence*

Individuals who in a year spend more than 183 days, consecutive or not, in Portugal, or who remain there for a shorter period in the year but have a house or other residence there on the 31st December and show an intention to reside regularly in Portugal, are considered to be residents of Portugal in that year, along with members of the same family. However, in the 2006 Annual State Budget, a long-heralded change was finally made, and since January 1st 2006, a spouse who has not resided in Portugal for more than 183 days will be considered non-resident, so long as the majority of his or her working activities have no connection with Portugal. In such a case, the resident spouse will be taxable on all world-wide income but the non-resident spouse only on income arising in Portugal.

1.3. *Tax treaties*

Portugal has entered into 49 double taxation conventions – namely those with Austria, Algeria (not yet in force), Belgium, Brazil, Bulgaria, Canada, Cape Verde, China, Chile (not yet in force), Cuba (not yet in force), Czech Republic, Estonia, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, India, Ireland, Italy, Latvia, Lithuania, Luxembourg, Macao, Malta, Mexico, Morocco, Mozambique, The Netherlands, Norway, Pakistan (not yet in force), Poland, Romania, Russia, Singapore, Slovakia, Slovenia, South Korea, Spain, Sweden, Switzerland, Tunisia, Turkey (not yet in force), Ukraine, United Kingdom, United States and Venezuela.

2. **Income Tax**

2.1 Personal income tax (IRS)

Portuguese personal income tax is divided into several categories, according to the nature of the income, as follows:

I) Employment (Category A)
II) Business activities and self employment (Category B)
III) Investment income (Category E)
IV) Rental income (Category F)
V) Capital and other gains (Category G)
VI) Pensions (Category H)

In the calculation of his taxable income, a resident taxpayer is entitled to a number of deductions – relating to his family and dependents and to his marital status and in respect of health, education etc.

I) Employment

All earnings and benefits – such as salaries, gratuities, commissions, annual prizes, family and residence allowances, daily expenses (in excess of a daily allowance of €57.98) interest-free loans, personal use of a company car, lunch allowance (in excess of €5.75/per day) – earned by employees pursuant to an employment contract are considered employment income. There is a specific tax deduction in the amount of €3.334.18, to be deducted from the gross income of the A category.

II) Business activities and self employment

Earnings arising from commercial activities or from the supply of services (lawyers, physicians, architects, etc.) There are two ways of computing income in this category – the "*Simplified assessment system*" and the "*Organized accounts system*". The *Simplified assessment system* is applied to individuals whose gross receipts from business activities do not exceed €149,639.37 and to service providers whose gross receipts do not exceed €99, 759.58.

The taxable income is determined by multiplying business receipts by 0.2 or multiplying receipts from provision of services by 0.65.

The *Organized accounts system* applies to individuals whose income exceeds the limits specified above, or who choose to apply this system. The tax is charged on worldwide income and the individuals are required to follow the accounting rules applicable to company accounts. The taxable profit is calculated in accordance with the provisions of the Corporate Income Tax Code. The usual expenses are deductible – e.g. the salaries of employees, meal and lodging expenses, lease on premises or equipment required for the taxpayer's activity. Some expenses are partially added back – e.g. car expenses (6%) and non-

documented expenses (50%).

III) Capital income

This category includes dividends, interest on loans and bank deposits, public debt interest, and profits arising from swap transactions, assignment of debts and similar operations, as well as the proceeds of redemption of life insurance policies.

IV) Rental income

Rent payable under a lease and all other income arising from the ownership of immovable assets are considered to be rental income. If, however, the income arises from a professional activity, it will be treated as Category B income. In calculating income taxable in this category, it is permissible to deduct various – e.g. those expenses, as connected with maintenance, cleaning, the provision of a doorman, premiums on insurance policies, municipal property tax (IMI).

V) Pensions

This category includes all income arising from retirement and disability pensions. There is a specific deduction from income in this category. (See below.)

VI) Capital gains

This category includes all gains generated by a transfer for value of immovable property, or by any sale of assets such as shares, intellectual property, warrants to bearer, derivative financial instruments, etc. (See below.)

VII) Deductions

The following deductions can be made in computing taxable income:

Expenses	%	Limit 2006 (EUR)
Health expenses (VAT exempt or subject to a 5% rate)	30%	No limit
Health expenses (subject to VAT standard rate)	30%	€ 59.00
Retirement home rent	25%	€ 323.00
Interest on loans on immovable property	30%	€ 549.00
Rents of home		€ 562.00
Renewable energies expenses	30%	€ 745.00
Life insurance premium	25%	€ 59.00 (unmarried) € 118.00 (married)
Health insurance	30%	€ 78.00 (unmarried) € 156.00 (married)
Investments in retirement funds	20%	€ 400.00 (-35 years old) € 350.00 (35-50 years old) € 300.00 (+50 years old)

2.1 Income Tax – Main Highlights

I) Top Rate

The rate of tax rises from 10.5% on the first €4,451.00 to 42% on income exceeding €60,000.

II) Marital status benefit

The total income of the spouses is divided into two ("income splitting"). For example, if one spouse has an income of €100,000, and the other spouse has no income, the applicable tax rate will be of 36.5%, as if each of the couple had an income of €50,000.

III) Investments

a) Capital gains arising from a sale of shares held for more than 12 months, and capital gains obtained from the sale of bonds or other debt securities are free of tax. Capital gains arising from the sale of real estate are only subject to tax on 50% of the gain.

b) We understand that, at this stage, there is a very interesting structure which can be set up with a trust or a foundation. The taxation of gifts or donations is subject to a territorial limitation: taxation only applies when the origin of the gift is in Portugal. We consider that if a proper structure is set up, whether with a trust or a foundation, outside Portugal, funds transferred from this entity to a beneficiary who is a tax resident in Portugal can be free of any taxation in Portugal.

IV) Pensions

Retirement pensions received by Portuguese residents are subject to tax on the normal worldwide basis. However, there is a specific deduction against income in this category, in the amount of €7,500 (not applicable to an annual income exceeding €40,000). Pensions received by a Portuguese resident from a foreign country with whom Portugal has a double taxation convention are usually subject to taxation only in Portugal. (See article 18 of the DTC's.) Some countries – the United Kingdom for example, and Portugal itself – allow a taxpayer to deduct a contribution to a pension in each year, but tax the pension when it is paid. Other countries, however, do not allow this deduction and do not tax the pensions, thus the transfer of residence after retirement (to a country that taxes the pension payments, as Portugal) may result in a disadvantage and if a pensioner from such a country moves his residence to Portugal he will suffer a tax for which he has had no allowance. There is no provision in Portuguese law for exempting from the capital element of a purchased annuity.

3. Property Tax.

3.1 Property transfer tax (IMT)

This tax is due in any acquisition for value of real estate in Portugal. Gifts or donations of real property are subject to stamp duty in a limited number of cases. The acquisition of property or land for construction are charged at a flat rate of 6.5%, whilst non construction plots are charged at a rate of 5%. The tax on a transfer of residential property rises from 2% on properties costing €83,500.00 to 6% on properties sold for €521,700.00 A transfer to a company resident offshore (i.e. in one of the territories listed in Portugal's "Black list") is taxed at 15%.

3.2 Municipal property tax

Municipal property tax is due by the owner of the immovable property (urban and construction buildings and rural land) on an annual basis. It is levied on the taxable value of each immovable property, and payable at the following rates:-

- Rural land – 0.8%
- Urban buildings – 0.4% to 0.8%
- Urban buildings evaluated according to the new regime (after 2004) – 0.2% to 0.5%
- Buildings owned by offshore companies – 5%

There is a special tax benefit, applied under certain conditions which, exempts the immovable property owners from this tax for a certain period. This exemption is only applicable to property used as a personal residence.

Value of the property	Period of exemption
Up to €150,000	6 years
From €150,000 to €225,000	3 years

4. Capital gains

As mentioned above, capital gains are subject to the same rate of tax as income. The amount taxable in any year is the difference between the capital gains and the capital losses of that year. In certain circumstances, only 50% of the gain is taxable.

Capital gains arising from the transfer of shares held by their owner for more than 12 months and from transfer of public debt and bonds are not chargeable. Sales of shares held for less than 12 months, the transfer of other securities and gains arising from derivative financial instruments, are taxed at a special flat rate of 10%, but the taxpayer has the option of including the gain in his income instead. Gains arising from a transfer for value of the taxpayer's personal residence are not taxed, provided that these gains are reinvested in the acquisition of another personal residence within a short period (generally 24 months after the sale).

5. Inheritance Tax

Since the property tax reform of 2004, gift and inheritance tax is not generally payable, but donated and inherited assets are subject to stamp duty. No stamp duty is payable on assets transmitted to the parents or children or between

spouses. Assets gifted to one inherited by more distant relatives or strangers carry stamp duty at a rate of 0.8% to 10%, depending on the type of asset.

6. Wealth tax

There is no wealth tax as such in the Portuguese tax system. However, the purchase of some assets (cars/houses/planes/motorcycles) above a certain value can be considered as a demonstration of wealth, and must be declared to the tax authorities. The taxpayer must declare the prescribed percentage of the cost of the goods, as follows:-

Goods	Exceeding Euros:	Minimum to be declared
Cars	50,000	50% of the acquisition value
Planes	No limit	100% of the value of the purchase
Houses	250,000	20% of the acquisition value
Boats	25,000	100% of the value of the purchase
Loans and shareholders loan made in the year	50,000	50% of the annual value
Motorcycles	10,000	50% of the acquisition value

If the taxpayer has declared in his tax return an income of less than 50% of the minimum income, the tax authorities may presume that he has an higher income.

7. Indirect Taxation

7.1. Value Added Tax - VAT

The VAT Code follows the guidelines of the 6th Directive, and is thus similar to the VAT Codes of the other EU member states. The reduced rate (e.g. on agricultural or farm products, newspapers, books, medications, electricity) is 5%, the medium rate (e.g. on restaurants, food, hotels, coffee and soft drinks) is 12% and the general rate (on all other goods or services) is 21%.

7.2. Other indirect taxes

As in other European countries, there are taxes on alcohol and beverages, tobacco, fuel and oils and cars. The tax on cars is higher than in most EU countries, but the taxes on tobacco and alcoholic beverages is much lower.

8. Example

Mr. John Smith, a 68 year old Englishmen, retired from his business activity in the City, and decided to spend his retirement years in Portugal, with his wife Patricia. John and Patricia purchased a wonderful villa in the Algarve for the price of €500,000.00. For that purchase they paid €29,147.00 in property transfer tax (IMT), and in the future they will have to pay each year an amount between €1,000 and €2,500, depending on the rate set by the Municipality, in municipal property tax (IMI), to be paid in two instalments – one in April and the second in September each year. However, they are pleased with their decision, because if they had bought the house through an offshore company, the property transfer tax (IMT) would have been of €75,000, and the municipal property tax would be of €25,000 per year. When the property is inherited by their sons no inheritance tax will be applicable in Portugal.

John receives a pension of €150,000 a year and also has some investments which bring him an additional income of around €150,000 per year – a third of it from dividends, a third from interest and a third from capital gains arising from sales of shares. Patricia does not have any income. When calculating his taxable income, John cannot benefit from the special deduction for pension income because it exceeds €40,000. Since John is now a Portuguese resident, he will benefit from the United Kingdom/Portugal Double Tax Treaty, and his pension income will not be subject to withholding tax in the United Kingdom, being subject to tax only in Portugal. As regards the investment income, the €50,000 of dividends may be subject to withholding tax abroad, and if it is he is entitled to a tax credit for the foreign tax. Only 50% of this income is taxable in Portugal.

If his interest income arises in another EU country, it will not be subject to withholding, because of the application of the European directive 2003/49/CE, but will be included in his total income and taxable in Portugal. If the interest is from Portuguese sources, a flat rate of 20% will be applicable. A flat rate of 10% is applicable to the capital gains arising from the sale of shares, amounting to €5,000.

To the pension income of €150,000, there will be added the amount of €25,000 (dividends) and €50,000 (interest). The total amount of €225,000 will be split between him and his wife and the top rate of 42% applied to each of them.

The tax due will be €94,500, less some deductions (Health Expenses, Education, the Tax Credit Deduction, etc.), as mentioned above.

SPAIN

Income tax

Many retired foreigners live in Spain, above all on the coast. However, they do so as non-residents. For this reason they pay their taxes in their countries of residence. In Spain they would only pay taxes on the properties that they own in Spain. The tax rate in this case is 25% and the taxable base is 5% of the value of the land. There is a possibility that the non-resident has formed a limited Company with the property that they have acquired. In this case, they would not pay income tax, as Companies are not subject to the Tax for possession of assets. In the case of a sale, either of shares in a real estate company or of a home, the non-resident will be taxed at 35% of the profits obtained, although, if the non-resident has included his property as an asset in a Limited Company, the sale of the property will only be taxed at 15% (18% in the future), as it would be taxed as a resident Company. It is not possible to create a trust in Spain. A trust may of course be created in another country; in that case the assets held by the trustee will be regarded in Spain as belonging to the trustee.

In Spain a person is considered to be a resident when he lives for more than 183 days a year in the country, not counting incidental absences. A resident is liable to income tax and must pay taxes on his worldwide income. If he owns assets worth over 108,000 Euros, he will be liable to capital gains tax on any capital gains. Currently the income tax rate is 45%, although a reform is planned for 2007 which will see the maximum rate fall to 43%. This is a marginal and progressive tax, and income over 46,818 Euros is subject to the maximum rate. Alimony payments made to a divorced partner are deductible expenses for income tax.

There are special provisions for older people. For example, the maximum level for contributions to pension plans up to 52 years of age is 8,000 Euros, which will be deductible from the income tax taxable base. After 52 years of age 1,250 Euros more can be contributed for every year they get older, with a maximum annual limit of 24,250 Euros for people that are 65 years old. It is not clear whether the Law in 2007 will continue to maintain this limit. If the pension benefit is paid out as a single sum, it will be taxed as irregular income and the rate of tax will be reduced by 40%. If the benefit is paid annually, it will be taxed as income at the full rate of tax. Where the taxpayer has paid a premium to purchase a lifetime annuity, the annuity is taxed, but the part of the return which corresponds to a premium, is not treated as income. Tax treaties take priority over domestic law, and in some cases they provide that income arising in the foreign country is to be taxed there and exempt from tax in Spain.