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FLASH | TAX

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Proposed Changes on the Mechanisms to Avoid the Double Taxation of Dividends

The proposed draft of the 2011 Budget Law ("Proposed Budget 2011") includes relevant changes to the mechanisms to avoid the double taxation of dividends foreseen in the Portuguese Corporate Income Tax ("CIT") Code. Double taxation occurs because corporations pay taxes on their annual earnings and, when these corporations pay out dividends to the shareholders, those dividend payments incur income-tax liabilities for the shareholders who receive them, even though the earnings that provided the cash to pay the dividends were already taxed at the corporate level.

The following set of rules are subject to changes under the Proposed Budget 2011: (i) the general dividend received deduction rule; (ii) the specific rules that apply to pure holding companies (*Sociedades Gestoras de Participações Sociais* – "SGPS"); and (iii) the rules that effectively eliminate the taxation of dividends distributed within a tax group.

Additionally, the Proposed Budget 2011 also includes changes to the withholding tax exemption rules on dividends distribution to EU corporate shareholders.

If approved, the proposed legislation will have an impact on: (i) the distribution of dividends within corporate groups with intermediate holding companies; (ii) all dividends received from participations representing less than 10% of the distributing entity's share capital; and (iii) dividends distributed by Portuguese entities to corporate shareholders that are resident in the EU and which have a participation lower than 10% of the distributing entity's share capital.

We set out below a brief explanation of the proposed legislative changes and a description of its main consequences.

1. GENERAL DIVIDEND'S RECEIVED DEDUCTION RULES

1.1. Current Rules

Portuguese companies may deduct from taxable income the total amount of dividends received where:

(i) Dividends are distributed by a company resident in Portugal or in a EU Member-state which is subject to Portuguese CIT or a similar tax;

(ii) The earnings that provided the cash to pay the dividends were effectively taxed; and

(iii) The beneficiary holds a participation, for a minimum period of one year, of at least 10% of the share capital of the distributing entity or such participation has an acquisition value of at least 20 million Euros.

The dividends received deduction is reduced to 50% on dividends from participations that do not comply with (ii) or (iii) above.

1.2. Proposed Changes

The Proposed Budget 2011 foresees two changes to this regime.

Firstly, under proposed rules, the deduction will no longer apply to participations where the acquisition cost is higher than 20 million Euros. Consequently, the dividends received deduction will only apply to dividends from participations representing at least 10% of the distributing entity's share capital.

Secondly, dividends from participations that do not comply with the requirements on (ii) or (iii) will be fully taxable, rather then 50% deductible under current rules.

1.3. Consequences

If these rules are finally approved, there are two situations where dividends will subject to increased taxation. The first will be dividends from participations lower than 10% with an acquisition value higher than 20 million Euros. These dividends will be fully subject to tax, whereas under current rules they are fully deductible.

The second will be dividends that do not comply with the requirements of (ii) or (iii) above. Currently, these dividends are 50% deductible. Under proposed rules, they will be fully taxable.

2. DIVIDENDS RECEIVED DEDUCTION REGIME APPLICABLE TO SGPS

2.1. Current Rules

Under current rules, the dividends received deduction applies to SGPS:

(i) Independently of the participation's percentage on share capital or its acquisition value; and

(ii) Independently of the earnings that provided the cash to pay the dividends being effectively taxed.

Consequently, under current rules, the dividends received by an SGPS are fully deductible provided that the distributing entity is resident in Portugal or the EU, has been subject to a CIT tax (regardless of having been effectively taxed) and the SGPS has held such participation for a period in excess of 1 year.

2.2. Proposed Changes

Under proposed rules, the special SGPS dividends received deduction rules will be repealed. As a consequence, SGPS will be subject to the deduction rules that apply to all other Portuguese companies, as described in 1. above.

2.3. Consequences

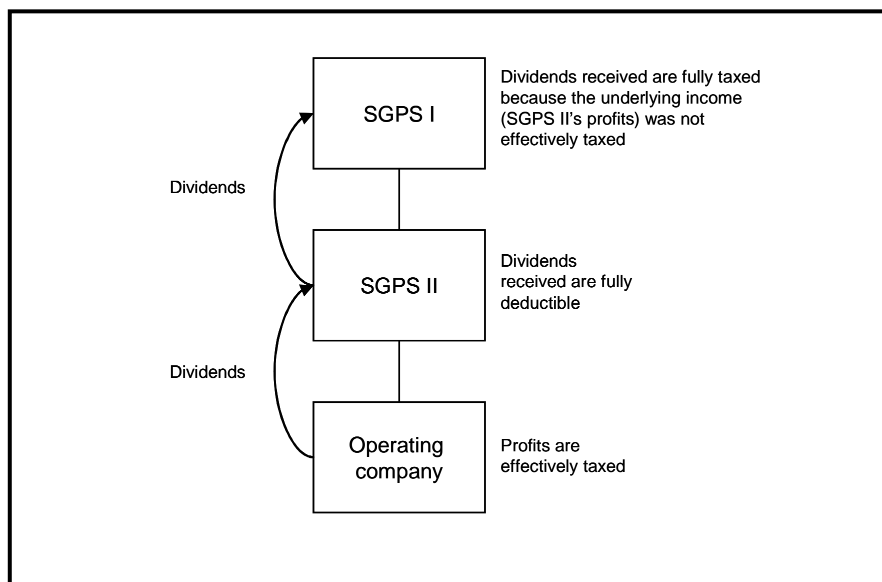
The proposed rules will have an adverse impact in two situations. The first will be the cases where an SGPS receives dividends from participations that represent less than 10% of the share capital. These dividends, currently exempt, will be fully subject to tax.

The second will be the case of dividends distributed from earning that were not effectively subject to tax. These dividends, currently exempt, will also be fully subject to tax, regardless of the SGPS participation in the distributing entity's share capital.

The later is particularly relevant because the Portuguese tax administration has expressly ruled[1] that dividends distributed by an SGPS to another Portuguese company ("Corporate Shareholder") from earnings that were not effectively subject to tax (including income that was deducted under the dividends received rules), are fully taxable at the Corporate Shareholder level.

Corporate structures that include an intermediate SGPS may give rise to double taxation of dividends. Under the proposed rules, dividends distributed from an operating company to an SGPS will still be fully deductible at the SGPS level, but will no longer be exempt when distributed to its shareholders, even if such shareholder is an SGPS.

The following exemplifies how profits distributed within corporate structures with intermediate holding companies may be subject to several layers of income taxation. In the example below, profits will be effectively taxed at the operating company level, they should be exempt at the holding company level when distributed as dividends, but would be subject to tax again at the top holding company level when received in the form of dividends. Schematically:



[1] This interpretation was given in *Despacho* P 1239/2007, of July 18, 2008.

3. DIVIDENDS RECEIVED DEDUCTION REGIME APPLICABLE WITHIN A TAX GROUP

3.1. Current Regime

Under current rules, dividends distributed within a tax group are eliminated from each of the group company's taxable income. As a result, these dividends are not subject to tax even where the dividends received deduction's general requirements are not fulfilled.

3.2. Proposed Changes

Under proposed rules, the special tax group dividends received deduction rules will be repealed. As a consequence, dividends distributed within the group will be exempt only to the extent the general deduction rules apply.

3.3. Consequences

The proposed changes to the dividends received exemption applicable to SGPS and to tax groups will trigger the multiple taxation effect described in 2.3. above also within tax groups.

If approved, these changes will have a dramatic impact on the organization of Portuguese groups and will likely trigger its reorganization during 2011.

4. WITHHOLDING TAX EXEMPTION ON DIVIDENDS DISTRIBUTED TO EUROPEAN CORPORATE SHAREHOLDERS

4.1. Current Regime

Under current rules, dividends distributed by Portuguese companies to European corporate shareholders are exempt from withholding tax provided that:

(i) The EU sharholder's participation has been held for an uninterrupted period of at least one year; and

(ii) It represents at least 10% of the Portuguese entity's share capital or had an acquisition value of at least 20 million Euros.

4.2. Proposed Changes

The proposed rules eliminate the 20 million Euros requirement.

4.3. Consequences

In case the proposed changes are approved, dividends from participations lower than 10% will not be exempt from withholding tax, regardless of the participation's acquisition value.

This withholding tax exemption is particularly relevant in the case of dividends distributed by companies with highly dispersed capital, in particular listed companies, as well as companies that have minority shareholders with a high acquisition value.

In most cases, this withholding tax will be an additional final cost for the shareholder, since, as a rule, these dividends are exempt at the EU corporate shareholders level and, consequently, will not be credited against their final tax liability.

5. ENACTMENT OF PROPOSED CHANGES

In principle, in case the approval follows its normal procedure, the proposed changes will be enacted in January 1st, 2011. Consequently, both the withholding tax rules and the dividends received deduction rules will be applicable to all dividends distributions made after such date.

Lisboa, November 16, 2010