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Draft Budget Proposes New Rules For Taxation of Dividends

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COUNTRY DIGEST

Draft Budget Proposes New Rules for Taxation of Dividends

Portugal's 2011 budget bill contains new rules on the taxation of dividends that would change the mechanisms for the avoidance of double taxation[1] in the Corporate Income Tax (CIT) Code. (For prior coverage of the draft budget, see *Tax Notes Int'l*, Nov. 15, 2010, p. 489, *Doc 2010-23921*, or *2010 WTD 215-3*.)

The proposed amendments would introduce changes to:

- the general dividends received deduction (DRD) rule that aims to prevent double economic taxation;
- the specific rules applying to pure holding companies (sociedades gestoras de participações sociais, or SGPS); and
- the rules eliminating the taxation of dividends distributed within a tax group.

The budget bill also includes changes to the withholding tax exemption rules for dividend distributions to EU corporate shareholders.

Once approved, the legislation will affect:

- the distribution of dividends within corporate groups with intermediate holding companies;
- all dividends received from shareholdings representing less than 10 percent of the distributing entity's share capital; and
- dividends distributed by Portuguese entities to corporate shareholders resident in the EU that hold less than 10 percent of the distributing entity's share capital.

If the approval of the budget bill follows its expected course, the proposed changes will be enacted on January 1. Therefore, the new withholding tax and DRD rules would apply to all dividend distributions occurring after that date.

If approved, the amendments will have a dramatic impact on the taxation of Portuguese groups and will likely trigger a wave of corporate group reorganizations in the first quarter of 2011, before the dividend payment "season." However, the tax administration has warned that the grounds for such reorganizations will be carefully scrutinized and has even threatened to deny rollover treatment to those that have no economic reason other than adjustment to the new rules.

Following is a closer examination of the proposed legislative changes and their main foreseeable consequences.

General DRD Rules

Current Rules

Under the current rules, Portuguese companies may deduct from their taxable income the total amount of dividends received whenever:

- dividends are distributed by a company resident in Portugal or in an EU member state that is subject to Portuguese CIT or a similar tax;
- the earnings that provided the cash to pay the dividends were effectively taxed; and
- the beneficiary holds at least 10 percent of the share capital of the distributing entity — or has a shareholding with an acquisition value of at least €20 million — for a minimum period of one year.

Up to 50 percent of the received dividends may still be deducted if the relevant shareholdings do not comply with the second and third conditions above.

Proposed Changes

Under the proposed rules, the deduction would no longer apply to shareholdings below 10 percent even if their acquisition cost exceeds €20 million. This means that the DRD would apply only to dividends stemming from shareholdings representing at least 10 percent of the distributing entity's share capital, regardless of their

[1] Portuguese law taxes income at the corporate level and also determines that shareholders receiving dividends incur income tax liabilities, thus posing eventual economic double taxation issues. Additionally, in a cross-border context, juridical and economic double taxation issues may arise, some of which have already been addressed in the EU parent-subsidiary directive (90/435/EEC), as amended by Directive 2003/123/EC, concerning the taxation of parent companies and their subsidiaries located in different EU member states.

acquisition value. Also, dividends from shareholdings that do not comply with the second and third conditions mentioned above would become fully taxable, rather than 50 percent deductible.

Consequences

If these rules are approved, dividends stemming from shareholdings of less than 10 percent with an acquisition value higher than €20 million would be fully taxable (whereas under the current rules, they are fully deductible) and dividends that do not comply with the second and third conditions mentioned above — which are currently 50 percent deductible — would become fully taxable.

Although this regime may seem to be more in line with the wording of the EU parent-subsidiary directive, it leaves out a number of situations in which dividends result from a shareholding with substantial economic value. The proposed measures may confer a greater degree of uniformity in the application of the deduction. However, in a small-scale economy such as Portugal's, and taking into account that the parent-subsidiary directive favors the imposition of minimum requirements rather than maximum harmonization, it would make sense to maintain the carveout for shareholdings of substantial economic value.

DRD Regime for SGPS

Current Rules

Currently, the DRD applies to SGPS regardless of the size of the shareholding and the effective taxation of the earnings that provide the cash for the dividend payout. This means that dividends received by an SGPS are fully deductible, provided that the distributing entity is resident in Portugal or in the EU and has been subject to CIT (regardless of having been effectively taxed), and that the SGPS has held the shareholding for at least one year.

Proposed Changes

Under the proposed changes, the special DRD rules for SGPS would be repealed. SGPS would thus be subject to the deduction rules that apply to all other Portuguese companies.

Consequences

The proposed rules would have an adverse impact in cases in which an SGPS receives dividends from shareholdings representing less than 10 percent of its share capital (these dividends, which are currently exempt, would become fully taxable) and when the distributed dividends correspond to earnings that were not effectively subject to tax (these dividends, which are currently exempt, would also be fully taxable, regardless of the size of the SGPS's shareholding in the distributing entity's share capital).

The latter situation is particularly relevant, to the extent that the Portuguese tax administration has enacted rules[2] establishing 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 DRD rules) are fully taxable at the corporate shareholder level.

Also, corporate structures including an intermediate SGPS may give rise to the double taxation of dividends. Indeed, under the proposed rules, dividends distributed by an operating company to an SGPS would still be fully deductible at the SGPS level but would no longer be exempt when distributed to the operating company's shareholder, even if the shareholder is also an SGPS.

The figure illustrates how profits distributed within corporate structures with intermediate holding companies may be subject to several layers of income taxation. In the example, profits would be effectively taxed at the operating company level, should be exempt at the holding company level when received as dividends, but would once again be subject to tax at the top holding company level when also received as dividends.

The effects of these changes that, in themselves, would already have an enormous impact on all corporate groups with multilevel holding structures would be further increased by the proposed rules on group taxation, as described below.

Tax Groups

Current Rules

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

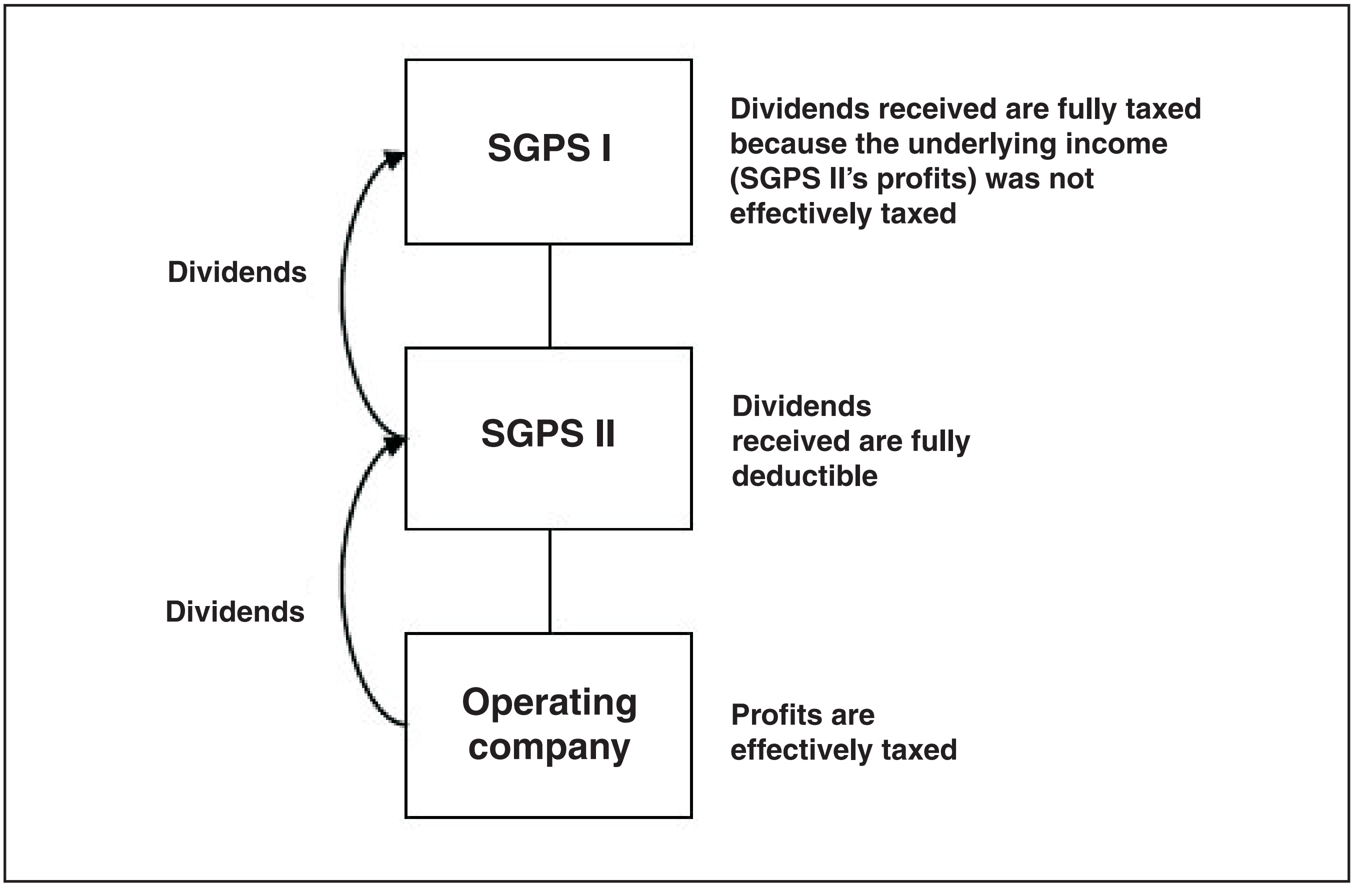
Proposed Changes

Under the proposed rules, the special tax group DRD rules would be repealed. As a result, dividends distributed within the group would be exempt only to the extent that the general deduction rules apply.

Consequences

The proposed changes to the DRD applicable to SGPS and to tax groups would also trigger the multiple taxation effect described above within tax groups. If approved, the changes would have a dramatic impact on the organization of Portuguese groups and would likely trigger their reorganization in 2011. Moreover, the absence of an actual tax consolidation regime could further aggravate the stringency of these issues

[2] This interpretation results from Administrative Order 1239/2007 of July 18, 2008.



and worsen the competitive disadvantage of the Portuguese tax regime when compared with other EU member states.

EU Corporate Shareholders

Current Rules

Under the rules currently in force, dividends distributed by Portuguese companies to EU corporate shareholders are exempt from withholding tax, provided that the holding has been held for an uninterrupted period of at least one year and that it represents at least 10 percent of the Portuguese entity's share capital or had an acquisition value of at least €20 million.

Proposed Changes

The proposed rules would eliminate the €20 million requirement, which would no longer be featured in the Portuguese tax rules.

Consequences

If the proposed changes are approved, dividends from shareholdings of less than 10 percent will not be exempt from withholding tax, regardless of the shareholding's acquisition value. This is especially relevant in the case of dividends distributed by companies with highly dispersed capital, particularly listed companies and companies in which minority shareholdings have a high acquisition value. In most cases, the withholding tax resulting from the proposed rules would be an additional final cost for shareholders since, as a rule, the dividends are tax-exempt in their home jurisdiction and shareholders would thus not be entitled to a tax credit against their final tax liability.

Final Comments

The 2011 budget bill does not hit companies with a deluge of new tax liabilities. However, like the traditional Jewish proverb that says, ''taxes grow without rain,'' the significant cuts in tax exemptions and benefits would certainly lead companies — particularly those organized in business groups — to either patch up their roofs or to seek far sunnier skies. ◆

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