INFORMATIVE NOTE

CORPORATE - TAX

NEW RULES ON THE TAXATION OF DIVIDENDS

I. MAIN CHANGES

With the entry into force of the law that approved the State Budget Law for 2011, the mechanisms for the avoidance of double taxation of dividends have been substantially modified and it is expected that the changes made will result in an increased tax burden, especially for groups of companies.

The main changes, in force since 1 January 2011, are as follows:

• The CIT (corporate income tax) exemption applicable to dividends distributed by entities resident in Portugal to entities resident in the EU[1] only becomes available when the parent company has owned, at least, 10% of the Portuguese company, for at least one year uninterruptedly prior to the date on which the dividends are payable (previously the exemption was also available whenever the beneficiary held less than 10% but the acquisition cost amounted to at least Eur. 20 million).

This measure penalises, above all, European companies that hold stakes in domestic companies with a high dispersion of the respective share capital, as with listed companies.

• Internally, the specific rules applying to pure holding companies (so-called "sociedades gestoras de participações sociais", abbreviated called SGPS companies) have been amended in the sense that now there is only a tax regime applicable to dividends, regardless of whether the beneficiaries are mixed holding companies or pure holding companies.

It should be remembered that pure holding companies (SGPS) benefited from a waiver of the requirements set forth in the CIT Code for companies in general in relation to the percentage or the purchase price held in subsidiary companies for the purpose of eliminating the double taxation of dividends distributed to them.

[1] Under the terms and conditions of article 2 of Directive No. 90/435/EEC of 23 July (now amended by Council Directive 2003/123/EC of 22 December 2003), hereafter referred to as the Parents-Subsidiary Directive.

"Portuguese Law Firm of the Year"
Chambers Europe Excellence 2009, IFLR Awards 2006 & Who's Who legal Awards 2006, 2008, 2009

"Corporate Law Firm of the Year - Southern Europe"
ACQ Finance Magazine, 2009

"Best Portuguese Law Firm for Client Service"
Clients Choice Award - International Law Office, 2008, 2010

"Best Portuguese Tax Firm of the Year"
International Tax Review - Tax Awards 2006, 2008

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• The exemption of 100% of dividends received is now dependent on the following cumulative requirements (for a more detailed analysis of the scheme, see the footnote below)[2]:

- The beneficiary of the dividends is required to hold a stake of not less than 10% of the share capital of the subsidiary (previously the exemption was also available where the recipient held a stake with an acquisition cost of at least Eur. 20 million)

and,

- The profits from which such dividends arise must first have been subject to *effective taxation*.

• Finally, and for the purposes of applying the tax group special regime (abbreviated called RETGS regime), dividends that would not benefit from total elimination of double taxation distributed among the companies that comprise the group perimeter may no longer be disregarded when calculating the group's consolidated taxable profits.

II. COMMENTS

1. Introduction

In fact, submitting the exemption of the dividends received to the requisite of *effective taxation*, without clarifying the concept, introduces uncertainty into the system and, as such, may contribute to economic groups restructuring or relocating.

Moreover, in designing a tax system that cuts across all companies, SGPS pure holding companies have been cut off from a substantial part of the more favourable tax regime applicable to them and which resulted from the recognition of their special characteristics.

It should also be noted that, by failing to ensure the sorting of legitimate models of company organisation from those that might be considered abusive, the new arrangements inevitably lead to groundless situations of discrimination, penalising the more complex structures organised on different levels as opposed to the others, thus calling into question the neutrality of interposing companies in several layers.

2. The concept of *effective* taxation

Several questions arise about how the concept of *effective taxation* should be interpreted.

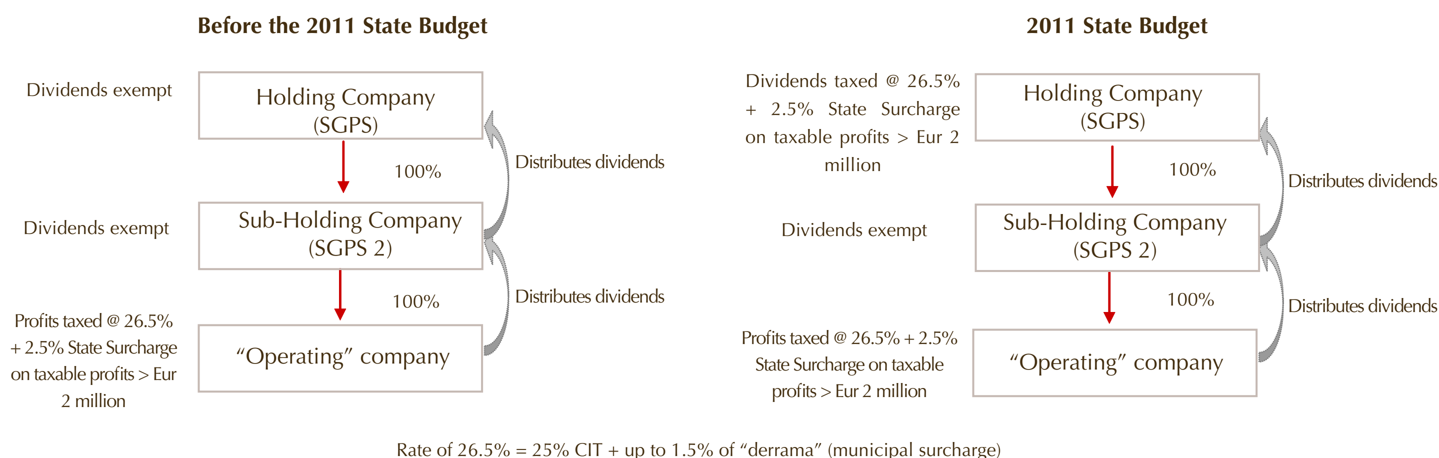
[2] According to article 51 of the IRC Code, revenue relating to distributed dividends will be deducted in full when determining the respective taxable income, provided that the following conditions are met:

- The company that distributes the profits is resident in Portugal and subject to and not exempt from CIT;
- The distributing company is not covered by the fiscal transparency arrangement;
- The company that receives the profits directly holds a stake of at least 10% in the share capital of the distributing company, provided that it has held such stake for an uninterrupted period of one year or, if held for a lesser period, the stake has been maintained long enough to complete such period;
- Income arising from dividends has been previously subject to *effective taxation* within the sphere of the entity paying the income.

Under article 51 (11) of the CIT Code, the exemption concerned also applies, under the same conditions, where the company distributing the dividends is resident in a Member State of the European Union, and provided that both companies (the payer and the beneficiary of the dividends) meet the conditions laid down in article 2 of Directive No. 90/435/EEC of 23 July, as amended by Council Directive 2003/123/EC, of 22 December 2003) - the "Parent-Subsidiary Directive."

As a starting point, we shall look at the following example:

INTRA-GROUP DISTRIBUTION
NEW REALITY OR "FICTION"?



Rate of 26.5% = 25% CIT + up to 1.5% of "derrama" (municipal surcharge)

The example immediately throws up the following questions:

- Is the relevant company required to have paid tax on distributed dividends, or is it only necessary for it to be subjectively subject to tax and not exempt from it?
- What is the "safe harbour" effective tax rate accepted for the purposes of *effective taxation* criteria being met?
- Must the distributed dividends have been subject to *effective taxation* within the sphere of the company distributing them, or can they simply have been taxed at lower levels along the distribution chain?
- How should *effective taxation* be gauged when the distributable dividends result from the combination of profits arising from a commercial activity and dividends received from subsidiaries?

Following the wording of the law, it seems that the concept of *effective taxation* is used with reference to the object (dividends) and not the entity distributing them.

In this sense, *effective taxation* should focus on a given flow of dividends, not on the entities involved in the chain of their distribution.

This first conclusion begs the question as to whether compliance with the new requirement of *effective taxation* is gauged by reference only to the entity paying the dividends, or, conversely, whether all layers of the respective distribution chain should be taken into consideration.

The text of the preparatory report to the 2011 Budget Law seems to conclude that the legislator's intention was to limit access to the mechanism for the avoidance of double taxation of dividends to cases where they have been subject to *effective taxation* within the sphere of the company distributing them.

However, such an interpretation seems contrary to the system of avoidance of double taxation adopted by domestic tax law, as well as the rules of EU tax law, which form the basis of article 51 of the Portuguese CIT Code.

Indeed, it is an assumption of the mechanism for the avoidance of double taxation that the distributed dividends have been subject to prior taxation, regardless of the amount paid and the level of the distribution chain at which this occurs. This is confirmed by the understanding of the Portuguese tax authorities as stated in Opinion no. 101/90 issued by the Ministry of

Finances' Centre for the Study of Tax Matters ("CEF"). In this Opinion, the tax authorities recognise that the principal aim of the avoidance of double taxation mechanism is to prevent dividends, which in principle have already been taxed, from being doubled taxed. The arrangement specifically aims to prevent the situation "where, within the chain of distribution of a dividend, an increased tax burden comes about simply because a parent company is interposed in between."

Therefore, and despite the wording of the law allowing a different interpretation, we believe that the underlying *effective taxation* should be assessed taking into account a given holding structure along which the income under consideration flows. To this end, it should be confirmed, layer by layer, whether the dividends have been subject to tax.

Closely connected to this is the issue of defining what are the acceptable cases of *effective taxation* of dividends.

As the 2011 Budget law does not impose any minimum taxation - as the legislature did, for example, in the case of the avoidance of the double taxation of dividends distributed by Portuguese speaking countries - the concept of *effective taxation* should be interpreted in the light of EU law, and specifically the Parent-Subsidiary Directive.

However, the aforementioned Directive does not provide any taxation threshold, or even a specific way of establishing one (so all systems aimed at treating taxable dividends in a narrow or segregated manner, such as, for example, "income boxes" or fiscal transparency /"look through" systems, may be discounted here). In fact, the Directive left to the EU States the option to eliminate the double taxation of dividends by choosing between one of the following methods: (i) the exemption method, or (ii) the tax credit method. Portugal clearly opted for the exemption method.

By choosing the exemption method, Portugal, and the Portuguese tax system, clearly positioned between the European participation exemption tax regimes that seek to ensure the neutrality of groups structured in several layers through the elimination of successive taxation of the same income. It is precisely this objective which distinguishes, and at the same time discounts, the participation exemption arrangement from the tax credit system.

Notwithstanding its simplicity, and contrary to what seems to have been the intention underlying the enactment of the new changes contained in the 2011 Budget Law, the participation exemption system, assures the prevention against tax abusive situations by resorting to the application of domestic anti-abuse provisions, such as the case of the general anti-abuse rule, or the CFC rules.

Understood in this way, and despite the different opinion that may result from a strict interpretation of the wording of the law, the requirement of underlying *effective taxation* will be met where and when certain dividends have been previously subject to income tax, or to similar taxes, and the same are included in the taxpayer's taxable base .

Only in this way can the non-discriminatory nature of the mechanisms for the avoidance of double taxation of dividends be ensured, particularly when dealing with proceeds from a domestic or foreign source.

3. Implications of the 2011 Budget Law for pure holding companies (SGPS)

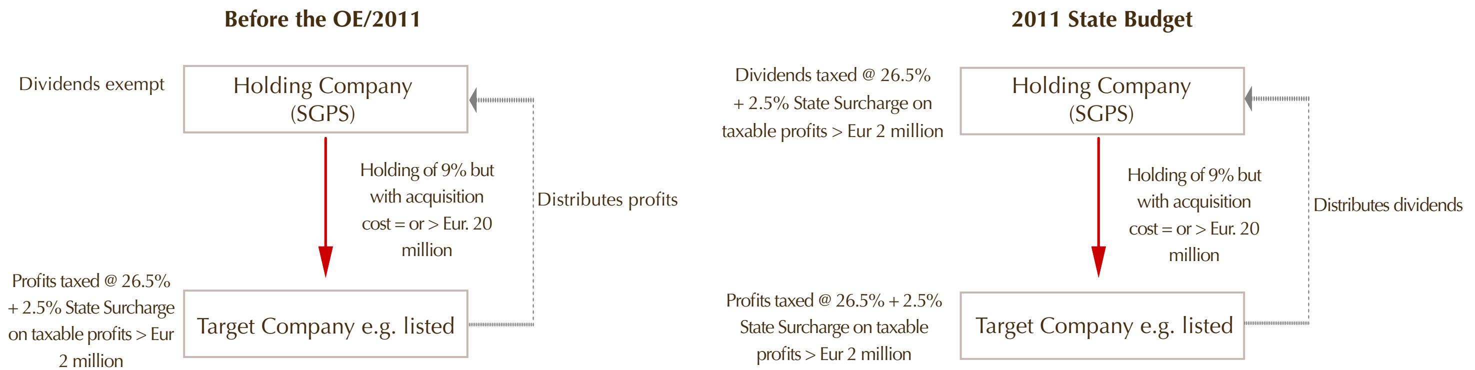
As is well known, until the entry into force of the 2011 Budget Law, pure holding companies (SGPS) benefited from a waiver of the requirements set forth in the CIT Code for companies in general in relation to the percentage or the acquisition cost of their stakes in subsidiary companies for the purpose of avoiding double taxation of dividends distributed to them.

Under the changes now introduced, not only does "direct access" to the exemption no longer apply but, perhaps more seriously, pure holding companies (SGPS) are subject to the same conditions applicable to mixed holding companies.

This means that in order for pure holding companies (SGPS) to be able to continue to benefit from the tax exemption mentioned, it is necessary not only that dividends have been previously subject to *effective taxation*, but that such dividends come from representative holdings of at least 10% of the share capital of each of its subsidiaries (whereas, previously, the alternative requirement could be met by owning a holding with an acquisition cost of at least Eur. 20 million).

The changes brought in may be illustrated by the following example:

DIVIDENDS DISTRIBUTED WHERE A SGPS HOLDS A MINORITY HOLDING



Rate of 26.5% = 25% CIT + up to 1.5% of "derrama" (municipal surcharge)

4. Comparison between the tax regime applicable to SGPS and to mixed holding companies

By losing one of its pillars, the tax regime applicable to pure holding companies (SGPS) is now less competitive, as per the following comparison:

	Dividends	Financial charges	Capital Gains	Auxiliary activities
Pure Holding Company (SGPS)	Exempt provided that: - Holding => 10% - Subject to prior *effective taxation* within the sphere of the entity paying the income Taxed in the other cases at 26.5% + 2.5% State Surcharge on the taxable profits exceeding Eur. 2 million	Non-deductible when (i) linked with the acquisition of participations and (ii) the capital gains on such participations are not taxable Deductible in the other cases (i.e., when capital gains are taxable or relate to interest bearing funding allocated to subsidiaries)	Non-taxable for CIT purposes where the relevant participations have been held for at least 1 year (or for at least 3 years in special cases) Taxed in the other cases at 26.5% + 2.5% State Surcharge on the taxable profits exceeding Eur. 2 million (a 50% exemption may apply in case of reinvestment)	Taxed in the other cases at 26.5% + 2.5% State Surcharge on the taxable profits exceeding Eur. 2 million
Mixed Holding Company	Same rules as for pure holding companies	Deductible whenever they are "indispensable" to generate profits subject to tax, or to pursue the company's activity	Taxable for CIT purposes. However, in certain cases, where the sales proceeds are reinvested, a 50% exemption may apply	Taxed in the other cases at 26.5% + 2.5% State Surcharge on the taxable profits exceeding Eur. 2 million

Rate of 26.5% = 25% IRC + 0-1.5% Municipal Surcharge

5. Implications of the 2011 Budget Law on the tax group regime

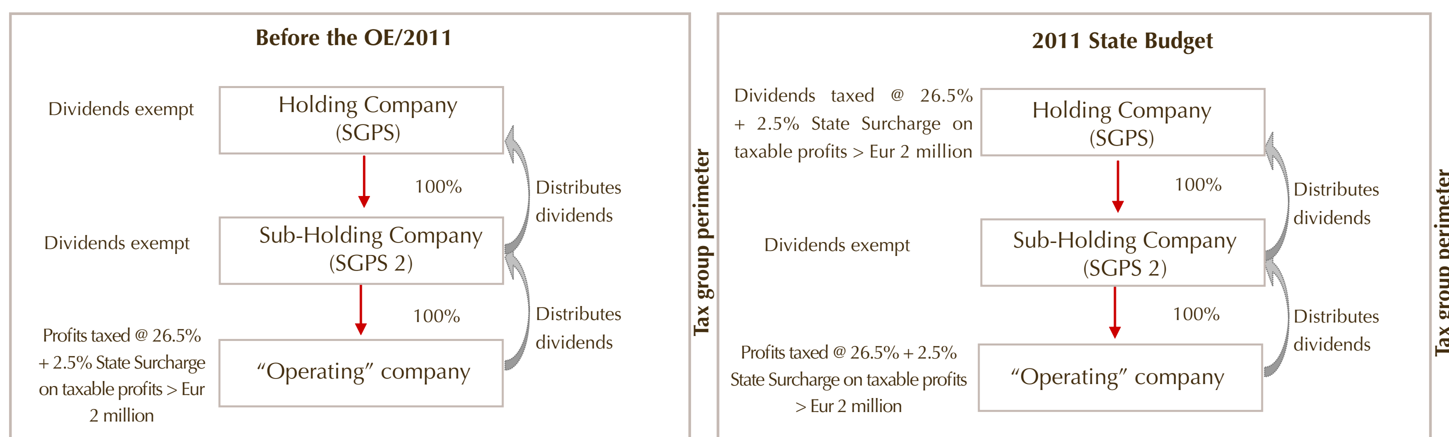
Prior to the entry into force of the amendments included in the 2011 Budget Law, dividends which did not benefited from full elimination of double taxation distributed within the perimeter of a tax group were deducted when computing the group's taxable profits. As a result, dividends were not subject to tax even when the conditions for the avoidance of double taxation of dividends were not met.

Now, under the new rules, such interim elimination has been abolished. As a result, dividends distributed intra-group shall only be exempt to the extend that the general mechanism for the avoidance of double taxation of dividends applies.

It should be noted, moreover, that this prerogative, if it remained, would constitute a safety valve for the system, allowing the negative effects associated with the new regime to be mitigated.

The changes brought in may be illustrated by the following example:

INTRA-GROUP DISTRIBUTION WHERE THE TAX GROUP REGIME APPLIES



Rate of 26.5% = 25% CIT + up to 1.5% of "derrama" (municipal surcharge)

III. CONCLUSIONS

The changes introduced by the 2011 Budget Law - both through the uncertainty they create in respect of the interpretation and practical application of the concept of *effective taxation*, and by reducing the tax competitiveness of pure holding companies (SGPS) - translate into factors that shake the classic models of organisation of Portuguese groups.

Moreover, the system for the avoidance of double taxation of dividends may now lead to different results depending on the organisational model adopted and this goes against the principle of tax equity.

We will therefore have to closely follow the initiatives that the Portuguese tax authorities may adopt, hopefully very soon, to clarify the doubts raised by the changes to the 2011 Budget Law, and at the very least, to take steps to restore levels of security and legal certainty in intra-group taxation of dividends and in doing so avoid unnecessary tax litigation.

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