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Portugal to Enact Anti-Tax-Evasion Measures

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Portugal's Parliament has authorized the government to enact legislation to fight tax evasion resulting from tax arbitrage techniques commonly referred to as bond washing and dividend stripping, specifically through cross-border transactions (Law 16-A/2002 of 31 May 2002).

Although no further information is available at this time, taxpayers should carefully note the government's intentions on this subject. Previous legislation on bond washing has been consistently interpreted by the Portuguese courts as being a mere interpretation of pre-existing tax rules and therefore was applied retroactively.

Bond washing and dividend stripping techniques are used to reduce a taxpayer's total tax liability, especially in cross-border transactions, either by arbitraging across different income streams that receive different treatment (source-based arbitrage), or by shifting income from high tax brackets to low tax brackets (rate-based arbitrage).

Bond Washing

Until 1992, bond washing was an extensively used tax arbitrage technique that basically consisted of the transfer of bonds, before each coupon payment, from residents to nonresidents, or to residents eligible for an exemption regime, so that an amount equivalent to the accrued interest received by the seller qualified as a capital gain, which at the time was tax-exempt for both resident and nonresident taxpayers.

The general tax treatment established for bonds is also applicable to public debt securities. However, the transfer and repurchase of public debt securities or their coupons, and the interest paid, are tax-exempt if held by nonresidents. Taxpayers have used that special treatment to avoid taxation by transferring public debt securities to tax-exempt taxpayers before any interest payments, and by repurchasing those same debt securities after payment of that interest.

In 1992 the Portuguese government amended the Personal Income Tax Code to counteract transactions made for the purpose of avoiding the taxation of bond interest by establishing that, whenever a bond is transferred, withholding tax is applied, based on a determination of the interest to which the seller would be entitled.

However, because sellers often are not identified as beneficial owners on a transaction-by-transaction basis, resident taxpayers have benefited from exemptions reserved for nonresidents. That possibility has been locked into place mainly through the channeling of investments through omnibus accounts, which do not identify the beneficial owners. As a result, bonds have been sold without any assessment of withholding tax on the accrued interest.

To fight new bond washing schemes, the government recently requested legislative authorization to counteract such tax avoidance operations. However, the legislative authorization is restricted to public debt securities and concerns only "the situation usually called 'bond washing,' by the sale of public debt securities from residents to nonresidents or residents that are subject to an exemption regime."

Dividend Stripping

The use of dividend stripping transactions is not dealt with by any specific antiavoidance rule, but the scope of legislative authorization is more extensive than that for bond washing. The authorization is aimed at "fighting dividend stripping by any operations, business, or legal acts, with equity or any right related to it . . . entered into by entities which are subject to tax and entities that, on whatever grounds, are tax exempt or subject to a more favorable tax regime."

Dividend stripping can apply to a range of operations, from a simple sale of shares with dividend, before the dividend distribution, and the repurchase ex-dividend of those same shares after the distribution of the dividend, to the more complex use of derivative financial instruments such as equity swaps.

Although nonresidents also may use dividend stripping arrangements to gain the benefit of the elimination of economic double taxation existing within domestic tax systems, the legislative authorization does not appear to prevent that situation.

Simulation and General Tax Avoidance Rules

Despite the nonexistence of specific antiavoidance rules on the subject, Portuguese tax law has both a simulation rule and a statute-based general antiavoidance rule (GAAR) that, in theory, could be used to counteract bond washing and dividend stripping.

However, Portuguese tax law adopts a narrow concept of simulation that is close to the private law concept. This would appear to make the simulation rule inapplicable to the series of transactions that bond washing and dividend stripping transactions require.

The GAAR also is inapplicable because the transactions involved in bond washing and dividend stripping techniques cannot be treated as a single transaction (a "step transaction") without any binding agreement between them. Finally, the GAAR is inapplicable because of the difficulty demonstrating tax avoidance as the "essential or principal" purpose of these cross-border transactions.

There are several nontax reasons that may be relevant in arguing that tax avoidance is not the sole purpose of the transactions — such as the need for financial liquidity, the avoidance of limitations on qualified holdings, or the avoidance of a limitation on rights as the result of an existing shareholders agreement.

Furthermore, other valid reasons may be put forward when taxpayers use derivative financial instruments in bond washing and dividend stripping transactions, such as avoidance of the cost of holding equity; the need to alter the mix of a portfolio of debt securities with equity returns; an attempt to speculate on price increases in the share markets; or the avoidance of limitations in foreign share holding.

It also may be argued that when the securities used in dividend stripping transactions are bought and sold on the public stock market, those transactions should be acceptable under the GAAR.

The government's need to enact specific antiavoidance rules is evidence that existing legal mechanisms are insufficient to counteract bond washing and dividend stripping transactions.

Drafting of Specific Antiavoidance Rules

Upon the drafting of the specific antiavoidance rules, the government must choose whether a definition of beneficial ownership is to be adopted, with a disallowance or reduction of the tax exemption when the requirements of that definition are not met or proved to tax authorities.

If so, the government also must opt for either a formal criterion such as a minimum holding period test or a material criterion based on a substantive definition of beneficial owner.

Although the adoption of a minimum holding period test might be easier to apply, it has a strong downside because it would affect bona fide business transactions and impose tax-motivated restrictions on the transfer of shares, which may significantly affect the stock market.

At the same time, the significant number of securities transactions that occur on the back stage of omnibus accounts held by institutional investors prevents the government from using the attractive but old-fashioned regime of identifying the parties in each transaction. A trade-off will have to be made to reconcile the need to stimulate the capital markets with the goal of fighting tax evasion, especially by residents.

The option of a substantive definition of the beneficial owner concept, however, is not an easy path either, because of the necessity to keep that definition vague to apply it effectively to the different transactions that may qualify as dividend stripping.

Also, a specific antiavoidance rule on this matter must address the question of tax authorities' power to connect a series of transactions to recharacterize the income flows and assess tax accordingly.

Therefore, antiavoidance rules should be aimed at and applied to only obvious bond washing or dividend stripping transactions. If any doubt exists, the taxpayer claiming the tax exemption or reduction should be treated as the beneficial owner, using reasoning similar to that contemplated in the draft EC Savings Directive for the determination of the beneficial owner.

Moreover, when applying both national antiavoidance rules and a national definition of beneficial ownership to cross-border transactions and imposing a withholding tax on the payment of interest and the distribution of dividends accordingly, attention must be paid, if applicable, both to double taxation conventions and to EC directives such as the Parent-Subsidiary Directive and, in the near future, the Savings Directive.

Finally, under the Portuguese Procedural Tax Code, the application of any antiavoidance rule must be preceded by a "specific procedure" in which the taxpayer must be heard. The "specific procedure" must be opened within a three-year period from the date of the transaction under scrutiny.

It will be interesting to see whether the new provisions will be enacted as specific antiavoidance measures or will appear outside of that scope, allowing tax authorities to hand over the provisions without following the path of the GAAR procedure.

The current economic climate and the weakness of the Portuguese capital market may prevent the government from enacting very aggressive antiavoidance rules, especially regarding dividend stripping transactions that may significantly affect the transfer of shares, and bond washing related to public debt. However, the need to fight tax evasion and to increase fiscal revenue to counter a high public deficit may prove to be a decisive argument for the adoption of specific antiavoidance rules for bond washing and dividend stripping transactions.◆

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