dateline Portugal

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UPDATE ON INTERCORPORATE DIVIDENDS, GAAR, ARBITRATION

Discussed below are new rules in Portugal on intercorporate dividends and the anti-avoidance regime; the first High Court decision on applicability of the general anti-avoidance regime (GAAR); and a new arbitration regime.[1]

New Rules on Taxation of Intercorporate Dividends

With the approval of the 2011 Budget that entered into force on the January 1, 2011,[2] the treatment of intercorporate dividends underwent important changes that may have a significant impact on corporate groups. In short, under the participation exemption regime for dividends that applied until the end of 2010, an exemption was available for dividends received by corporate entities resident in Portugal if (1) the recipient had a participation of at least 10% or with an acquisition cost of at least €20 million in the capital of the subsidiary held uninterruptedly for the year prior to the dividend distribution; and (2) the distributing subsidiary was also a company resident in Portugal or another state of the European Economic Area (EEA). Basically, Portuguese law follows closely the requirements of Directive 90/435/EEC, as amended by Directive 2003/123/EC (EU Parent-Subsidiary Directive).

If these requirements were not met, half of the dividends received would be exempt from corporate income tax. Moreover, under the anti-avoidance regime, only half of the dividends were exempt if the above requirements to benefit from the exemption were complied with but the dividends were distributed out of profits that "were not subject to effective taxation." This anti-abuse regime did not apply if the beneficiary was a Portuguese holding company (*sociedade gestora de participações sociais*) (SGPS).

The new regime makes three important changes: (1) the acquisition cost of at least €20 million no longer applies, so the exemption now applies only to shareholdings with a minimum threshold of 10%; (2) elimination of the partial exemption when the requirements for the exemption were not satisfied; therefore, if the exemption does not apply, the dividends received will be fully taxed (with credit for international double taxation, if applicable); and (3) introduction of a new very stringent anti-avoidance rule whereby, notwithstanding that the requirements are met, the exemption does not apply if the dividends were not subject to effective taxation. As mentioned, the previous version of this anti-avoidance rule was not as strict, as the exemption still applied if there was no effective taxation but the recipient of the dividends was a SGPS.

This last amendment is the subject of much controversy. First, the tax authorities have not yet provided any guidance on the meaning of "effective taxation." Is €1 of corporate income tax paid equivalent to effective taxation? And what if no tax was paid because the distributing company had tax losses from previous years? Should a subsidiary subject to a reduced corporate income tax rate (e.g., 12.5% or less) be considered subject to effective taxation? Also, it is unclear whether the requirement of effective taxation must be satisfied by the distributing company or if it sufficient

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to demonstrate that the profit has been taxed in any earlier stage of the participation chain. What is clear is the intent to enlarge the tax base subject to corporate income tax and increase the tax revenues.

Corporate groups that are now in the process of reorganizing their portfolios to move away from the application of this anti-avoidance rule should be aware that the tax authorities have created a special team to scrutinize these types of changes and reorganizations. Therefore, special care and precaution should be exercised when making these plans.

An increase in litigation is foreseeable if the tax authorities apply this rule blindly where there is no abuse. For instance, it is common that an operative company effectively taxed is held by an intermediate holding that, in turn, is held by a parent company located in Portugal. As the intermediate holding probably does not pay tax on the dividends received, the distribution of dividends to the parent company will not benefit from the participation exemption under a literal application of this new anti-avoidance rule. However, according to this rule, if there is no intermediate holding and the parent company receives the dividends directly from the operative subsidiary, the participation exemption would apply. In this situation, it is our understanding that the existence of an intermediate subsidiary does not by itself represents an abuse, so the rule should not apply.

Moreover, application of this rule in relation to dividends derived from European subsidiaries may be contrary to the Treaty on the Functioning of the European Union (TFEU) and, more probably, the Parent-Subsidiary Directive. Application of the rule can be contrary to the TFEU because it may constitute an obstacle to invest in companies resident in other member states as, if it not clear to the Portuguese investor whether the subsidiary has paid corporate tax in its state of residence, it may well be discouraged to invest in that company.

Further, notwithstanding that anti-avoidance rules may generally be considered a justification to restriction of the treaty, it is also clear that that restriction must comply with the proportionality principle (i.e., the tax authorities cannot take measures that would go further than necessary to prevent the tax abuse in question). This new rule may be considered to go beyond what is necessary to prevent abuse; the taxpayer is not entitled to prove that there was no abuse as the rule applies automatically.

The new rule may also be considered to go against the Parent-Subsidiary Directive because, according to Article 4(1) of the Directive, the residence state of the parent company either exempts the dividends (with no further requirements) or taxes those dividends and grants an indirect foreign tax credit. However Portuguese law does not foresee any indirect foreign tax credit in the present situation, so double taxation will not be relieved.

First High Court Decision on Applicability of GAAR

Almost 12 years after introduction of GAAR in Portuguese tax law, the South Administrative Central Court has issued the first opinion on this matter. Due to the technicalities of Portuguese tax procedure law, this decision was not rendered on the legality of the additional corporate income tax assessment by the tax authorities based on the application of GAAR, but on a previous matter—the decision by the head of the tax administration that authorized the application of GAAR.

Portuguese GAAR. The Portuguese GAAR (Article 38/2 of the Portuguese General Law on Taxes) reads:

> Any legal documentation or formalities, aimed by artificial or fraudulent means and by abuse of the legal forms, wholly or mainly at reducing, eliminating or postponing taxes that would be payable as a result of facts, legal documentation or formalities with the same economic purpose, or to obtain tax advantages that would not be achieved in whole or in part without the use of these means, shall be ineffective for tax purposes, and taxation shall proceed in accordance with the rules that would have applied in their absence and the tax advantages referred to shall not arise.

United States Postal Service
Statement of Ownership, Management and Circulation

1. Publication Title	2. Publication Number	3. Filing Date
Journal of International Taxation	009-197	10/3/11
4. Issue Frequency	5. No. of Issues Published Annually	6. Annual Subscription Price
Monthly	12	$480.00

7. Complete Mailing Address of Known Office of Publication: 195 Broadway, New York, NY 10007-3124
Contact Person: Jennifer Kelson
Tel: (212) 337-4102

8. Complete Mailing Address of Headquarters or General Business Office of Publisher: 3 Times Square, New York, NY 10036

9. Full Names and Complete Mailing Addresses of Publisher, Editor, and Managing Editor
Publisher: Thomson Reuters, 195 Broadway, New York, NY 10007-3124
Editor: Robert Gallagher, 195 Broadway, New York, NY 10007-3124
Managing Editor: Sandra K. Lewis, 195 Broadway, New York, NY 10007-3124

10. Owner

Full Name	Complete Mailing Address
Thomson Reuters	3 Times Square, New York, NY 10036

11. Known Bondholders, Mortgagees, and Other Security Holders Owning or Holding 1 Percent or More of Total Amount of Bonds, Mortgages, or Other Securities. If none, check box > X

Full Name	Complete Mailing Address

12. For Completion by Nonprofit Organizations: N/A

13. Publication Title: Journal of International Taxation
14. Issue Date for Circulation Data Below: 8/31/11

15. Extent and Nature of Circulation		Average No. Copies Each Issue During Preceding 12 Months	No. Copies of Single Issue Published Nearest to Filing Date
a. Total Number of Copies (Net press run)		673	663
b. Paid Circulation	(1) Mailed Outside-County Paid Subscriptions	224	209
	(2) Mailed In-County Paid Subscriptions	0	0
	(3) Paid Distribution Outside the Mails	0	0
	(4) Paid Distribution by Other Classes of Mail	0	0
c. Total Paid Distribution (Sum of 15b (1), (2), (3), and (4))		224	209
d. Free or Nominal Rate Distribution	(1) Free or Nominal Rate Outside-County Copies	34	35
	(2) Free or Nominal Rate In-County Copies	0	0
	(3) Free/Nominal Rate Copies Mailed at Other Classes	0	0
	(4) Free or Nominal Rate Distribution Outside the Mail	34	24
e. Total Free or Nominal Rate Distribution (Sum of 15d (1), (2), (3), and (4))		68	59
f. Total Distribution (Sum of 15c and 15e)		292	268
g. Copies not Distributed		381	395
h. Total (Sum of 15f and 15g)		673	663
i. Percent Paid (15c divided by 15f times 100)		76.71%	77.99%

16. Publication of Statement of Ownership
X If the publication is a general publication, publication of this statement is required. Will be printed in the October 2011 issue of this publication. — Publication not required

17. Signature and Title of Editor, Publisher, Business Manager, or Owner: Jennifer Kelson, Fulfillment Coordinator — Date: 9/2/11

I certify that all information furnished in this form is true and complete. I understand that anyone who furnishes false or misleading information on this form or who omits material or information requested on the forms may be subject to criminal sanctions (including fines and imprisonment) and/or civil sanctions (including multiple damages and civil penalties).
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Facts. Between 2000 and 2002, Company A, resident in Portugal for tax purposes, used a subsidiary, Company B with headquarters in the international business center of Madeira (Portuguese special tax regime), to transform interest paid by indirect subsidiaries in the Netherlands and the Channel Islands, which otherwise would have been subject to corporate income tax, into exempt dividends.

Specifically in those tax years, Company A transferred amounts to be loaned to the foreign subsidiaries to Company B via informal capital contributions. Company B then financed the foreign subsidiaries. The foreign subsidiaries paid interest to Company B, which benefited from the more favorable tax regime of Madeira (0% on interest received). Company B then distributed dividends to Company A, benefiting from the Portuguese participation exemption regime on dividend payments.

The Portuguese tax authorities found that the anti-avoidance clause applied and assessed additional corporate income tax of several million euros. The lower court and the High Court agreed with the tax authorities.

New Arbitration Regime

The Portuguese government recently enacted Decree-law 10/2011, which creates and generally regulates dispute resolution between taxpayers and the tax administration through arbitration, avoiding the use of the judicial system. This new arbitration regime was enacted primarily to prevent judicial litigation and reduce the number of suits pending in the tax courts, ensure taxpayers' rights, and solve, in a quick and uncomplicated way, disputes between taxpayers and the tax authorities by delivering the matter to one or more impartial arbitrators who will listen to both parties and decide the issue according to the established law (the use of equity is specifically prohibited). An arbitrator's decision will have the same validity as a decision by a tax court. The new regime entered into force on July 1, 2011.

Requisites for the use of arbitration and subsequent procedure. Taxpayers may request arbitration to invalidate income tax assessments and withholding taxes, and to determine, among other things, taxable income, taxable amount, and property value. First, the taxpayer informs the Administrative Arbitration Board of his intention to resort to arbitration. The case is heard by one arbitrator if the taxpayer chooses not to appoint an arbitrator and the amount in question does not exceed €60,000, and by three arbitrators if the taxpayer chooses to appoint an arbitrator or the amount in question exceeds €60,000. When there are three arbitrators, either the Administrative Arbitration Board appoints them or the taxpayer and the tax authorities each appoint one and the third (chief) arbitrator is appointed by the first two.

Arbitrators must be lawyers with at least ten years of experience in tax matters, although, if necessary, management or economics experts can be appointed. To ensure that arbitrators are independent and impartial, they must not have had any professional relationship (direct or indirect) with the taxpayer or the tax authorities within the previous two years.

Decree-law 10/2011 establishes that the arbitrators must reach a decision within six months. If they do not, the period can be extended for up to six months. To encourage taxpayers to choose arbitration, expenses will not be charged during the first year that the regime applies for disputes that have been pending in the courts for more than two years.

The final verdict: challenge and appeal. The arbitration decision on the merits of the claim is not subject to appeal in every circumstance. If it is not eligible for appeal or challenge, and it benefits the taxpayer, the tax administration must comply with the exact terms of the verdict from the expiry of the deadline for appeal or dispute, until the expiry of the deadline for the compliance with judgments in the tax courts. (The normal deadline for the tax authorities to comply with court decisions is 30 days. If they do not, the taxpayer must initiate a new action to compel them to comply.) Decisions on the merits adopted in arbitration procedures that cannot be challenged or appealed preclude the right to judicially or administratively challenge the same tax administration's act (or subsequent tax assessments) on the same factual or juridical basis.

The final arbitration decision may be challenged in a court of appeal only where the factual or legal grounds have not been specified, there is a contradiction between the decision and its announced foundations, the decision is excessive or omissive regarding the initial claim, or there is a violation of equality or "contradictory process principles."[3]

Further, the taxpayer or the tax authorities may appeal to the Constitutional Court if the arbitrators refuse to apply a law on the ground that it is unconstitutional or apply a rule that a party has questioned as unconstitutional. Parties may also appeal to the Administrative Supreme Court if the arbitrators' holding is contrary to previous decisions by the court of appeal or the Supreme Court on the same fundamental juridical matter. ●

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1 In this article, "anti-avoidance regime" and "anti-abuse regime" are used synonymously. In addition to GAAR, Portuguese law has several specific anti-abuse rules (e.g., thin cap, CFC).

2 See Fugas and Neves, "Portugal—2011 Draft Budget Law," 22 JOIT 61 (January 2011).

3 "Contradictory process principle" is a free translation to English of the Portuguese expression *principio do contraditorio*. It derives from the equality principle and means that the judge is obliged to hear both parties before making a decision.