European Commission Challenges Withholding Tax on Dividends Distributed to Nonresident Companies

On 25 July 2006, the European Commission sent a formal request to several EU Member States, including Portugal, requesting that the countries amend their domestic regimes governing outbound dividend distributions to companies resident in another EU Member State or the European Economic Area - EEA (i.e. the EU Member States as well as Iceland, Liechtenstein and Norway).

According to the Commission, the Portuguese domestic regime imposes a heavier tax burden on dividend distributions made to EU or EEA Member States than that on distributions between Portuguese resident companies.

Under Portuguese domestic legislation, dividend distributions between Portuguese companies are exempt from withholding tax if the requirements in article 46 of the Corporate Income Tax Code are met, i.e. the recipient holds at least 10% of the capital of the distributing company (or the acquisition value of the shareholding amounts to at least Euro 20 million) for at least one year before the distribution. In the case of a pure holding company, only the one-year holding requirement must be met.

However, a company resident in an EU Member State may only benefit from a withholding tax exemption on dividends received from a Portuguese company if the requirements of the Parent-Subsidiary Directive (as transposed into Portuguese domestic legislation) are met, namely:

- The recipient holds at least 20% of the share capital of the Portuguese company; and
- The shareholding has been held for an uninterrupted period of two years prior to the dividend distribution.

In the case of dividend recipients in EEA Member States, a reduced rate is possible only if so provided in an applicable tax treaty, with the exception of Liechtenstein, which is considered a territory subject to a privileged tax regime as set forth in Ministerial Order No. 150/2004 and with which Portugal has not concluded a treaty.

In light of the above, and regardless of the compatibility of Portugal’s regime with the Parent/Subsidiary Directive, the Commission considers that the imposition of the above conditions on dividend distributions by Portuguese companies to companies resident in an EU or EEA Member State is incompatible with the EC Treaty and EEA Agreement because it restricts the freedom of capital movement and the freedom of establishment.

The Commission, therefore, has requested that Portugal amend its domestic legislation to end the discriminatory treatment. If Portugal does not respond positively to this request within two months, the Commission may refer the case to the European Court of Justice.

In light of the above, it is likely that the provisions applicable to dividend distributions made by a Portuguese company to a company resident in an EU or EEA Member State may be harmonized with the provisions applicable to distributions between resident entities.
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