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Will Brazil Derail Madeira Investment Route?

by Phillippa Cannon and Francisco de Sousa da Câmara

Madeira is under siege. On June 30 Brazil's Ministry of Finance announced the unilateral termination of the 1971 income tax treaty between Brazil and Portugal effective January 1, 2000. This announcement came with the publication of *Ato Declaratorio* No. 53 of June 17, 1999.[1] (For prior coverage, see *Tax Notes Int'l,* July 26, 1999, p. 352, or *1999 WTD 135-1,* or *Doc 1999-23943 (3 original pages).*)

The unilateral termination of a double tax treaty is a rare and diplomatically shocking occurrence. In the last 14 years only nine treaties (including the Brazil-Portugal treaty) have been unilaterally terminated (see Table 1).

In this instance the diplomatic missile was fired against Portugal as a whole, but it seems that its real target was Madeira's International Business Centre. According to Everardo Maciel, Brazil's federal Revenue secretary, investment through Madeira has led to an unacceptable derogation of Brazilian tax revenues. The emotive term "tax evasion" was cited as the rationale behind the ministry's move. Is there evidence to substantiate this claim?

The Madeira Regime: Incentives Tempered by Control

Tax Incentives

The establishment of the free zone in Madeira was authorized in 1980, but it was only at the end of the 1980s that its tax system was developed and consolidated. At that time several important regulations were approved to organize trade, industry, shipping, and international and financial services (including insurance and separate regimes for pure and mixed holding companies) in the zone.

In the 1990s, further regulations were approved. During this phase, the initial idea of creating a mere free zone was superseded by the creation of an International Business Centre (IBC). At the same time several measures were introduced to control and prevent tax evasion and the abusive use of the IBC of Madeira by Portugal residents.

Tax incentives were granted to encourage development of the above-mentioned business sectors, thereby promoting employment in Madeira. The goal was to move the economy from its traditional base (agriculture and tourism) toward finance and industry.

Each type of activity benefits from completely different tax incentives, as indicated in article 41 of the Portuguese Tax Incentive Statute, until the year 2011.[2] This scheme has proved to be a double-edged sword. On the one hand, Madeira has successfully tailored incentives to the achievement of its investment goals.[3] On the other hand, this fragmented approach has understandably created difficulties for investors, who often assume that an incentive applicable in one area is available across the board. This misconception has probably also contributed to the pejorative qualification of Madeira's regime as an

[1] Alberto Xavier, a well-known professor of tax law in Brazil, has already stated that this was unconstitutional.

[2] In this article, references to Madeira companies mean companies licensed to operate in the IBC by the regional government of Madeira.

[3] *See* Francisco de Sousa da Câmara "Madeira Free Zone: Tax Exemptions and Financial Incentives," *European Taxation,* April 1990, p. 87-90.

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Table 1
Unilateral Treaty Terminations Since 1985[a]

Countries	Date Signed	Date Entered Into Force	Effective Date of Termination	Terminated By
U.S.-South Africa income tax treaty	December 13, 1946	July 15, 1952	July 1, 1987	U.S.[b]
U.S.-Malta income tax treaty	March 21, 1980	May 18, 1982	January 1, 1997	U.S.
Denmark-Portugal income and capital tax treaty	March 3, 1972	December 22, 1973	January 1, 1995	Denmark
Brazil-Portugal income tax treaty	April 22, 1971	October 10, 1971	January 1, 2000	Brazil
Germany-Kuwait income and capital tax treaty	December 4, 1987	July 14, 1989	January 1, 1998	Lapsed and not renewed
Extension to Faroe Islands of Denmark-U.K. income tax treaty	1950		April 1997	Denmark
Extension to the Netherlands Antilles and Aruba of the U.S.-Netherlands income tax treaty	1948		January 1, 1997	U.S.

Source: Tax Analysts

[a]Kazakhstan and Armenia both unilaterally announced in 1995 that they would no longer honor tax treaties concluded by the Soviet Union.

[b]In accordance with the U.S. Comprehensive Anti-Apartheid Act of 1986.

offshore center. This has fueled debate at the European Commission level and may account for the readiness of some elements within Portugal itself to criticize the regime. Unfortunately, this misconception seems to have led the Brazilian authorities to denounce the treaty with Portugal.

Controls

Under the Portuguese tax system, all Madeira companies are subject to tax. As mentioned before, the applicability of tax exemptions depends on the activities of a company and the type of income received. To control this regime, the Portuguese system demands that Madeira companies comply with the following requirements:

companies must obtain a license, granted by the regional government of Madeira, to operate in the IBC of Madeira. Investors must present an application stating the purpose of the company and complying with several other legal criteria;

companies are incorporated by a public notarial deed and must be registered in the Commercial Registry Department;

companies must keep accounts as well as books, auxiliary records, and supporting documents for a period of 10 years;

companies must present periodical tax returns for corporate income tax and VAT purposes;

companies must comply with all Portuguese regulations regarding social security, shipping, banking, and insurance activities. Even pure holding companies (SGPSs) must fulfill an enormous amount of material obligations (substantive measures concerning their activities) and formal requirements (the delivery of information to several entities, including the General Tax Inspectorate that supervises all SGPSs);

companies may be subject to tax audits and in certain circumstances the tax authorities may make assessments for corporate income tax or VAT purposes. The EU directive on mutual assistance may also be invoked to investigate and inspect Madeira companies. In practice, this has already happened for VAT purposes;

directors may be held liable for the taxes eventually assessed to the company when the latter does not have the means to pay. Some authors even espouse the view that in the absence of all supporting documents the tax authorities have the authority to make assessments to companies operating in the IBC of Madeira using a rate of 60 percent in accordance with Decree Law 192/90 of June 9, 1990, as later amended.

Madeira in the EU

Madeira is an integral part of Portugal according to the Portuguese Constitution. Madeira was expressly included in Portugal's accession act to the EEC. Unlike the Channel Islands or Cyprus, Madeira is part of the European Union.

To stimulate the economy of the ultraperipheral island of Madeira, which has a GDP of slightly more

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than half the EU average, the European Commission approved the installation of a special tax regime in 1986. The European Commission accepted that this presented no conflict with the Treaty of Rome, on the grounds that the incentives are a form of state aid to promote economic and social cohesion within the European Union. Subsequent evaluations (in 1989, 1991, and 1994) affirmed the continuing validity of the regime with reference to economic indicators. The number of jobs directly created by the International Business Centre amounted to 1,650 by 1998 (see Table 2), although the average annual expenditure per capita still amounted to just 69.7 percent of the national average in 1995.

Table 2
Number of Direct Jobs in MIBC*

Years	Total	
	Jobs	Growth
1991	300	
1992	500	66.67%
1993	545	9.00%
1994	758	39.08%
1995	1,111	46.57%
1996	1,433	28.98%
1997	1,478	3.14%
1998	1,650	11.64%

Sources: SDM — Madeira Development Company

*Excluding the International Shipping Register (MAR)

A new vigilance on the part of the European Union and the OECD could represent a second form of siege of Madeira. The EU committee on harmful tax measures has already drawn up a provisional list of special regimes that may represent unfair tax competition. For the time being there is still uncertainty regarding whether Madeira's regime for financial, insurance, and international service companies will appear on the final list. Provided sufficient evidence is presented, the continuing economic and social justification for Madeira's incentives should safeguard their future.

Tax Treaty Network

Portugal's network of 19 enforceable double tax treaties (18 if the Brazil treaty is excluded) is an intrinsic aspect of Madeira's investment appeal. These treaties cover Madeira, and more particularly, the companies licensed to operate in the IBC of Madeira. All conventions signed by Portugal specify that "Portugal" includes the continental part of the territory and the islands of Azores and Madeira.[4]

In general, Portugal has adopted the ordinary credit method to relieve double taxation, but the majority of its treaty partners have adopted the exemption method. Therefore, it is likely that foreign investors in the Madeira IBC will not be taxed in Portugal for income arising therein (source state) in accordance with the specific legislation applicable to them in the IBC. Nor will they normally be subject to tax in their state of residence (full exemption). In relation to dividends, interest, and royalties, Portugal's treaty partners have tended to adopt the credit system. Brazil applied the credit method to all types of income.[5] The only possibility for Brazilian investors was to benefit from tax deferral, but this is equivalent to the benefit of investing in any treaty partner country.

Brazil's current onslaught is not the first time that Madeira's treaty status has been attacked. Notably, in 1994 Denmark terminated its 1972 treaty with Portugal, stating that the tax-sparing clause in the treaty had led to the effective and unacceptable exportation of jobs abroad.[6] A minority of the treaties to which Portugal is a party include tax-sparing clauses, granting a credit in the recipient's country of residence even when Portuguese tax was not imposed. However this was not the case with the Brazil-Portugal treaty, which did not provide for tax sparing.

In 1992 a protocol was attached to the Spain-Portugal treaty. With one exception, this protocol denied treaty relief on Spanish-source dividends, interest, royalties, and capital gains to Portuguese-resident companies when the majority of shareholders in the company are nonresidents of Portugal and vice versa. However, implementation of the Parent-Subsidiary Directive preserved the tax advantages of a number of Madeira structures. Finally, article 17 of the U.S.-Portugal treaty contains a limitation of benefits clause, which makes reference to Madeira, similar to that found in the U.S.-Netherlands treaty.

New Treaty With Brazil

The latest episode in the treaty denunciation saga suggests that a new treaty between Brazil and Portu-

[4]Regarding the applicability of tax treaties to Madeira companies, *see* Maria Margarida Cordeiro Mesquita, "Aplicação das convenções sobre dupla tributação a empresas instaladas nas zonas francas da Madeira e de Santa Maria," *Direito e Justiça*, vol. XI, Tomo 2, 1997.

[5]After the publication of Brazilian law No. 9.249/95, domestic withholding tax rates cannot be higher than those prescribed in the treaty for dividends (15 percent).

[6]*See* Leif Weizman, "Government Blocks Madeira Route," *European Taxation,* September 1994, p. 315.

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gal will be signed this year. This will fill the treaty void, but it seems that Madeira will be excluded. This way, Portuguese investment in Brazil, which amounted to US $3 billion in 1998, will be safeguarded. Portugal is the third largest foreign investor in Brazil's privatization program, after the United States and Spain. Portugal Telecom, the electricity group EDP, and the construction group Somague, among others, have all made sizeable investments in Brazil. Brazilian investment in Portugal is also huge. It is publicly known that the vast majority of these investments were not made using the Madeira route. Nonetheless, all investors who chose the Madeira route will be penalized by exclusion from the treaty.

The nonapplicability of a treaty to specific persons within a country is a measure that requires reflection and deliberation. Exceptions and discriminations must be justified in accordance with the equity principle. If two entities have the same, or equivalent, regime there is no reason to treat them differently. As explained above, Madeira's tailored tax system is not compatible with the per se exclusion of companies licensed to operate in the IBC of Madeira. These can be companies subject to tax. These can be companies that pay tax. These can even be companies that pay more taxes than similar entities located in Lisbon or in other Portuguese territory where other special incentives apply.

In this context, a well-considered measure that does not hurt Portuguese and Brazilian companies' and citizens' interests requires that politicians and tax technicians find specific, technical ways to prevent abuse of the treaty. Citizens, and indeed regions, should not fall victim to the whims of politicians.

Which Tax Policy for the Madeira IBC?

The negotiation of a new treaty leaves Madeira in a vulnerable position. If the Portuguese government is perceived to have sacrificed Madeira in this instance, it seems likely that other treaty partners will seek renegotiations along similar lines. The exclusion of Madeira is in conflict with the direction of Portugal's international tax policy since the creation of the IBC of Madeira. It is also ironic that the International Tax Reform Committee appointed by Portugal's Minister of Finance made treaty protection of Madeira a central plank of its recommendations delivered in March this year (for prior coverage, see *Tax Notes Int'l,* June 21, 1999, p. 2520, or *1999 WTD 118-6,* or *Doc 1999-21331 (4 original pages)*.) Brazil's denunciation of the treaty raises the specter of unfair tax competition. The European Union and the OECD are attempting to referee the area of preferential tax regimes, but Brazil's actions show that some countries are creating and policing their own definitions.

Are these definitions and judgements fair? Brazil's federal Revenue secretary claims that Madeira is being used for tax evasion, but so far it has not released any statistics or evidence to support this claim. Is the Madeira regime worse or more harmful than the hundreds of tax measures already under discussion at the European Commission level, or is it just the most high-profile tax-planning opportunity for Brazilian investors?

On January 1, 1996, Brazil moved from a territorial to a worldwide system of taxation. Some observers said that this led to renewed interest in Madeira on the part of Brazilian multinationals; companies located abroad and controlled by Brazilian parents are excluded from the scope of the new law when a double tax treaty exists between Brazil and the country in which the subsidiary is located. But in fact, according to information from SDM-Madeira Development Company (the entity that supervises the IBC of Madeira), of the 3,400 companies registered in the Madeira free zone, less than 100 are directly owned by Brazilian enterprises (see Table 3). Only these directly owned companies could eventually benefit from the Brazil-Portugal double tax treaty.

Conclusions

In the present context evidence seems to be an irrelevant commodity. Brazil has claimed but not substantiated tax evasion. Taken together, the applicability of a credit method, the absence of a tax-sparing clause, and the existence of low (15 percent) domestic withholding tax rates in Brazil make it difficult to understand what exactly Brazil is defending itself against.

It is also difficult to understand why Portugal does not demand the insertion of a precise antiabuse clause rather than accepting the wholesale deletion of Madeira from the treaty. In reality, Brazil has just as much to lose from the absence of a treaty as Portugal. At the end of the day, both Brazilian and Portuguese companies and individuals are caught in the middle of this investment duel.

In connection with other treaty partners and in the EU arena, the onus is now on Portugal to make a convincing case for the continuing existence of the Madeira IBC. Probably due to internal disputes between opponents and supporters of the IBC of Madeira, this case has been left undefined. Economic agents and investors feel that there is no sharp definition on the horizon. The IBC is left floating at the mercy of political winds of change.

It is expected that the expectations and vested rights of Madeira's IBC remain valid at least until 2011. But now a questions mark hangs in the air. Le-

gitimacy in the past may not be enough to sustain Madeira in the future if treaty problems undermine its efficacy. Will the EU member states defend the inclusion of Madeira's regime in the context of a code of conduct, while nonmember states demand its treaty exclusion?

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