PORTUGAL

Madeira Free Zone Legislation Amended

By Dr Francisco de Sousa da Câmara*

I. INTRODUCTION

A. Madeira Free Zone legal regime

Madeira island is part of Portugal's territory for international purposes (i.e., it is a full member of the EC through Portugal and benefits from the application of Portugal's treaties). In general, all Portuguese legislation is also applicable to Madeira, and in particular its tax laws. However, it is well known that a tax-free regime exists within Madeira island: the Ruding Report itself recognizes this when it refers to the principal tax differences between EC Member States.

In spite of being meant to be a mere trade and industry free zone with a well-defined geographical area (Caniçal Zone), Madeira has also become an offshore centre with international service facilities, allowing the incorporation of companies for trading, holding and management. Companies which intend to pursue a trading or holding activity may apply to the Regional Government of Madeira for the tax-free regime, may be installed in the centre of Madeira (specifically in Funchal, the main town), and may recruit employees or use the services rendered by local accounting companies.

The incorporation of these companies does not require the normal fees paid in Portugal to the Notarial and Commercial Registry Departments or to the ICEP (Portuguese Foreign Trade Institute) when the quota or shareholders are non-residents and the operation qualifies as a foreign investment operation. In fact, the investor only has to pay an application fee and an operating fee to Madeira Development Company (hereinafter "SDM", SA) which manages and administers the Zone and which gives a preliminary opinion on the project submitted to the Madeira Government. For pure or mixed holding companies (see below) the application fee is US$ 750 and the annual operating fee is now US$ 1,500. Thus, the initial costs of incorporation should only include the fees to SDM, the legal counsellor and the accounting company, which is responsible for the accounts of the Madeira company. In addition, the accounting company also appoints directors and provides an address for the Madeira company head office, when requested.

B. Amendments to Madeira Free Zone tax regime

The Madeira Free Zone regime was modified recently by Decree-Law No. 84/93 of 18 March 1993. The status quo was maintained for the majority of situations (operations and activities) which have benefited since 1986 from various tax exemptions and financial incentives.[1] In fact, these exemptions are granted automatically but temporarily until 31 December 2011. Until then legally acquired rights and even lawful expectations should be respected under the maxim "rules cannot be changed during the game" since to make changes would conflict with taxpayers' rights.[2]

Contents

The explanatory preamble of the above Decree-Law, which modified Article 41 of the Tax Incentive Statute (hereinafter "EBF"), *inter alia*, states the following:

> The evolution of the process of European financial integration (...), as well as the experience acquired with the system of fiscal incentives granted to the trade zones of Madeira and Santa Maria Island, justifies a re-definition of their respective frameworks in order to avoid economic distortions in the territory of Portugal and to re-affirm the principle that these benefits are not applicable to operations involving residents in the aforementioned territory.

---

* João Morais Leitão & Associados, Lisbon, Portugal. The author would like to thank Miguel-Angel García Caballero of the staff of the International Bureau of Fiscal Documentation and Mrs Isabel García, Lisbon, for their helpful suggestions.

1. See *Guides to European Taxation*: Vol. II, *The Taxation of Companies in Europe*, Portugal, 2.3.5.4.2.3.; García Caballero, M.A., "Portugal – The New Tax Incentive Statute", 29 *European Taxation* 9 (1989), at 304; de Sousa da Câmara, Francisco, "Portugal – Madeira Free Zone: Tax Exemptions and Financial Incentives", 30 *European Taxation* 4 (1990), at 87.

2. The tax exemptions are automatically granted (until 31 December 2011) with a licence issued by the Regional Government of Madeira to the companies resident there. The licence is an administrative act on which the taxpayer can rely.

Despite the statement that this principle is being reaffirmed, it is important to stress that it has never before been affirmed. Nevertheless, no doubts can arise about the future. One of the most important amendments now introduced concerns the tax treatment of dividends with the creation of a distinct regime for holding companies (regulated by Decree-Law No. 495/88 of 30 December 1988) and other companies such as service companies which hold shares and quotas. The term "pure holding companies", as used here, refers to an "SGPS" as defined in II.A. Companies holding participations and also having a direct business activity will be called "mixed holding companies" (see II.B).

Under the general tax regime of Madeira Free Zone, corporations or branches that have obtained a "licence" from the Madeira Government are exempt from corporate income tax (hereinafter "IRC") on income and capital gains from their activities carried on within the Free Zone (for an explanation of what is meant by an activity carried on in the Zone, see IV.B.). In addition, shareholders of these companies are exempt from individual income tax (hereinafter "IRS") if they are individuals or from IRC if they are companies.

At this point it should be stressed that income generated in mainland Portugal cannot be remitted to Madeira to benefit from either of the tax advantages mentioned above. As has been indicated, in the relationship between mainland Portugal or any other part of the Portuguese territory and Madeira Free Zone no special tax benefits apply.

Within the territory of Portugal the distribution of dividends may be subject to one of the following five ordinary regimes: (a) the tax credit system; (b) the transparency regime; (c) the affiliation regime for mixed holding companies; (d) the affiliation regime for pure holding companies; or (e) the consolidation regime.

Moreover, the coexistence of several regimes – the domestic one with its two aspects (the ordinary regime and the exempt regime of Madeira for either pure or mixed holdings), the one resulting from the application of Portugal's bilateral tax treaties and the one emerging from the introduction of the EC Parent-Subsidiary Directive – justifies a special examination of these issues. This article will describe the main features of the new scheme regarding the payment of inbound and/or outbound dividends as well as distributions within the territory of Portugal. It also explores some opportunities for clarifying and solving the problems involved.

II. PURE AND MIXED HOLDING COMPANIES

A. Pure holding companies

Decree-Law No. 495/88 of December 30 1988 changed the legal regime of holding companies, previously regulated by Decree-Law No. 271/72 of August 2 1972. Under the new regime any holding company (hereinafter "SGPS") in Portugal – including in Madeira Free Zone – must have as its exclusive object the "management of participations in other companies as an indirect form of conducting a business activity":

A participation in the capital of another company is considered to be an indirect business activity whenever:

a) it is not occasional; and
b) it reaches at least 10% of the voting rights of the company in which it participates.

For this purpose the law considers a participation to be not occasional provided that it is held by the holding company for a period of at least one year. Furthermore, at least 75% of the total fixed assets of the holding company, as stated in the balance sheet, must be composed of participations in other companies, equivalent to at least 10% of the voting rights of the companies in which the participation is held.

Thus, the addition of all quotas or shares which are not substantial (less then 10% of the voting rights) cannot represent more then 25% of the tangible assets held by the SGPS. On the other hand, only these quotas or shares can be traded within the period of one year.

It is permissible for a holding company to buy participations in foreign companies on the same terms and conditions applicable to the acquisition of participations in companies subject to Portuguese law. Nevertheless, there are several operations expressly forbidden by law to holding companies.[3] Any acts contrary to this prohibition are null and void. In addition, if SGPSs are engaged in direct business activities they can be wound up by a court order and be subject to heavy fines.[4]

In the present context, Portugal's tax law is almost exclusively based on its commercial law. Therefore, only the "pure holdings", i.e. SGPSs, were expressly regulated by means of a specific commercial and tax regime. The most important commercial features of these SGPSs are described above. Depending on the specific tax regime economic double taxation may be practically abolished because 95% of the dividends received by SGPSs are exempt from IRC, regardless of the percentage or period of ownership in the paying company.[5] In addition, capital gains realized from the disposal of financial assets (i.e. the sale or exchange of shares or quotas in the company in which the participation is held) are exempt from IRC if the entire consideration received is reinvested in the acquisition of other shares or quotas or Government securities within two years after such a disposal.[6] Finally, interest

3. A pure holding company (SGPS) is forbidden by law:
(a) to buy its own shares or "quotas", except in two special cases;
(b) to buy bonds in companies where it does not hold a participation or "quotas", except bonds convertible into shares;
(c) to sell or encumber its own bonds;
(d) to buy buildings and real estate, except buildings necessary for its own offices;
(e) to give loans, except to companies where it holds a participation of at least 10% of the voting rights of the company in which it is participating by means of:
- loan contracts;
- purchase of bonds issued by the company in which the participation is held up to the percentage equivalent to the participation;
(f) to sell or encumber a participation lower than 10% within one year as from its purchase, unless the sale proceeds are applied for the purchase of other participations within six months for an exchange of participations.

4. Articles 8(2) and 13(1) of Decree-Law No. 495/88 of 30 December 1988.

5. Article 7(1) of Decree-Law No. 495/88 of 30 December 1988 and Article 45 IRC.

6. Article 7(2) of Decree-Law No. 495/88 of 30 December 1988 and Article 44 IRC.

paid to pure holding companies is exempt from withholding tax if paid on loans or bonds by a company in which the SGPS has a direct or indirect participation of at least 10% for the whole year.

B. Mixed holding companies

For the purpose of this article "mixed holding companies" are those that, despite their specific direct business activities, hold participations in other companies. Four aspects should be pointed out regarding these companies. First of all, it is important to stress that Portuguese law does not recognize them as "holding companies" for business purposes. Secondly, it should be noted that the domestic affiliation privilege tax regime grants special treatment to these companies regarding the avoidance of double taxation, provided that the receiving company owns at least 25% of the shares or quotas of the paying corporation for two years or since the incorporation date of the paying company. Thus, only 5% of the dividends received are subject to IRC at a rate of 36%.[7] Thirdly, according to the Supplementary Proposal for the Budget Bill of 1993, capital gains realized from the disposal of financial assets (as indicated above) are subject to IRC and the entire consideration cannot be reinvested with the purpose of avoiding taxation. Fourthly, one must always keep in mind that companies with a specific objective broad enough to involve a direct business activity (i.e., companies which are not necessarily SGPSs), but which do not develop this activity at all (acting in fact as pure holdings) can be wound up and may also be subject to the payment of certain fines.[8]

C. Pure and mixed holdings in Madeira Free Zone

1. Previous regime

Until the publication of Decree-Law No. 84/93 of 18 March 1993 the tax-exempt regime of Madeira for companies did not distinguish between SGPSs and ordinary companies holding participations in other companies. Therefore, inbound or outbound dividends were considered exempt from IRC provided that they were received or paid, respectively, by corporations that qualified for the "Madeira tax regime". Under the provisions existing up till then it seemed that all dividends paid to Madeira companies should be exempt from IRC, including those paid by Portuguese companies with their head offices in mainland Portugal.

Taking into consideration the huge commercial limitations and restrictions imposed on SGPSs – shown above – as well as the similarity of the tax regime granted to pure and mixed holdings in Madeira Free Zone, very few investors have decided to incorporate an SGPS in Madeira. In addition, resident share or quotaholders were also exempted from withholding tax and IRC or IRS, whatever the case, on dividends and similar distributions received from Madeira companies.

2. Present regime

With the introduction of a special tax regime for SGPSs, the situation has changed. As indicated above, the door connecting mainland Portugal and Madeira Free Zone has been closed. This was accompanied by the proclamation of a principle never affirmed before (see I.). Nowadays, dividends distributed from mainland companies to Madeira companies, as well as from the latter to the former companies, are subject to the regime described in II.A. and II.B.

a. *Pure holding companies*

Holding companies (SGPSs) established in Madeira Free Zone are exempt from IRC in relation to the income derived from shareholdings in companies which are not resident in the territory of Portugal, except for those in the Free Zone or in other Member States of the European Community. Therefore, that these SGPSs are companies which are not only subject to tax but which must pay effective taxes if they receive dividends from the Free Zone or from any EC country is unquestionable.[9] It is understandable of course that the Portuguese legislator tried to qualify these companies for the Parent-Subsidiary Directive by the nuance that will be explained below.

However, it is important to stress that unfortunately the Portuguese legislator forgot to exempt those companies (SGPSs) from corporate income tax on the capital gains derived from the sale of shares or quotas in the foreign companies in which a participation is held, because there is only a reference to "income derived from shareholdings" (Article 41(1)(g) EBF) and it will be very difficult for anyone interpreting the law to stretch the term "income" to cover "capital gains" in this context.

Nevertheless, one should also remember that non-resident companies without permanent establishments in Portugal are exempt from IRC with respect to capital gains realized from sales of shares, quotas and other securities. Therefore, if a Madeira SGPS cannot avoid payment of IRC when it realizes a capital gain (except by reinvestment, as explained below), the foreign parent company may instead sell the participations of the Madeira SGPS intermediate holding company.

Capital gains derived by a Madeira SGPS from the sale of participations may benefit from the ordinary Portuguese regime, which allows the reinvestment of the entire consideration in the acquisition of other shares, quotas, company bonds or Portuguese central government bonds within a tax period of two years. In either case, these securities may not be disposed of during a minimum period of two years. If only part of the proceeds are reinvested, only the corresponding amount of the gain qualifies for exemption.

On the one hand, if a Madeira SGPS distributes dividends to its Portuguese parent company – another SGPS or any mixed holding company – only the ordinary Portuguese domestic tax system applies. On the other hand, if the Madeira SGPS distributes dividends to foreign parent companies no withholding tax will be levied, except if the income corresponds to dividends received from mainland Portugal (for an illustration of these points, please see Diagrams I and II and Tables II and III).

7. Article 45 IRC.
8. Articles 8(2) and 13(1) of Decree-Law No. 495/88 of 30 December 1988.
9. Article 41(g) EBF.

Thus, if a Madeira SGPS receives dividends (100) from an American, Japanese or former Portuguese colony's (for example, a Mozambican or Angolan) subsidiary, the latter can redistribute them intact (100) to an EC parent company or to the Portuguese parent company without any withholding tax at source. However, in the latter case, the Portuguese parent company (e.g. an SGPS) will be subject to IRC at the effective rate of 2% if no further costs can be deducted from its taxable income. For example: (5) x 39.6% (where 36% corresponds to the corporate income tax rate and 3.6% corresponds to the municipal surcharge levied by many municipalities).[10] If the Portuguese parent company derived the dividends directly without passing through Madeira, these would be subject to corporate income tax at the normal rate of 36% plus the municipal surcharge because the common worldwide income rule is applicable, which subjects to tax all income derived in Portugal or abroad.

One can also say that the Portuguese corporate income tax code (CIRC) requires that subsidiaries "... must be subject to and not exempt from IRC ..." to benefit from the affiliation privilege (Article 45(1) IRC) with the purpose of denying the application of this regime when the parent company is established in mainland Portugal and the subsidiary in the Free Zone of Madeira. However, in the author's opinion, the affiliation privilege is applicable in these cases, because the exemption mentioned in Article 45(1) IRC corresponds to a subjective, total and permanent exemption, which is not the case for Madeira subsidiaries. Moreover, the author's opinion is also based on the administrative rule No. 4/91 of 30 January 1991, which clarifies the meaning of Article 45(1).

Therefore, assuming that a Portuguese pure holding company receives dividends from Madeira subject to a 2% effective corporate income tax rate, it can redistribute the same income to the final quoted stock exchange parent company (SGPS), where the dividends will again be subject to tax at an effective rate of 2%. Finally, distributions from quoted shares to individuals or corporations, resident or non-resident, are only subject to an effective tax rate of 15% (only 60% is taxable income), plus a 5% substitute inheritance and gift tax. If the recipient is a SGPS this 5% does not apply.

On the other hand, if a Madeira SGPS receives dividends (100) from a Portuguese or EC subsidiary, those dividends will be subject to tax. The affiliation privilege will apply in both cases, but in the latter case it is necessary to respect the requirements of the Parent-Subsidiary Directive (a minimum shareholding (25%) must be maintained for a period of two years), as will be indicated below. The SGPS may then redistribute the dividends abroad without withholding tax if they correspond to EC dividends or with a withholding of, at least, 10% (in cases where a treaty is applicable) if the income is derived from mainland Portugal. To avoid payment of the supplementary withholding tax, the Madeira company can also try to reconvert the income into "interest" or "royalties".

In fact, shareholders of Madeira companies are exempt from IRS/IRC and withholding tax on interest and other forms of payment for loans or capital contributions made by them to the company. In addition, individuals or corporations outside the Free Zone are also exempt from IRS or IRC on royalties derived from industrial or intellectual property, technical assistance or the transfer of know-how, provided that the arm's length principle is respected.

b. *Mixed holding companies*

International service companies such as mixed holdings located in Madeira Free Zone are exempt from IRC for income derived from activities carried on within the "institutional ambit of the respective zone", provided that their income is a result of activities or operations carried out with entities located in the Free Zone or with non-residents of Portugal, except for their permanent establishments located there but outside the Free Zone. Thus, dividends received by these companies are exempt from IRC whenever they come from the Free Zone or abroad without any distinction between EC and other countries.[11] This non-discrimination aspect constitutes one of the major differences *vis-à-vis* a pure holding company. The other main difference results from the fact that a mixed holding company is exempt from corporate income tax if it derives any capital gains from the sale of foreign participations. When it derives capital gains from the sale of Portuguese participations the ordinary regime mentioned above is applicable.

In any case, it is important to stress that these companies are subject to tax. The exemption granted to them is specifically limited to the income derived from the "institutional ambit of the Free Zone", and should be understood as an objective and temporary exemption (until 2011). This also explains why the Portuguese tax treaties – which include Madeira and the Azores in the term "Portugal" – also cover these companies. In addition, the EC Parent-Subsidiary Directive should as a result also be seen as covering these companies in spite of the difficulties that could be raised by the tax authorities of the EC Member States, including the Portuguese authorities.

Residents of Portugal, on the other hand, will no longer benefit from the exemption of IRC or IRS if they receive dividends from Madeira companies, except if they are paid by entities located in the industrial free trade zone or the dividends correspond to income derived by duly licensed entities that carry on maritime transport activities, except those related to the transport of cargo or passengers between national ports.[12]

III. APPLICATION OF PORTUGAL'S TREATIES TO MADEIRA COMPANIES

By now it is well known that the 14 treaties signed by Portugal for the avoidance of double taxation cover Madeira and, more particularly, the Madeira Free Zone companies.[13] For inbound dividends the general tax policy of Portugal is

10. Note, however, that no *derrama* is charged in the 11 municipalities of Madeira or the 19 municipalities of the Azores. Out of 305 municipalities in 22 districts only 118 municipalities in 17 districts imposed the *derrama* in 1993 and only 11 municipalities charge *derrama* at 10%.
11. Article 41(h) EBF.
12. Article 41(3)(b) EBF.
13. A comprehensive tax treaty was signed by Portugal and Ireland on 1 June 1993 but the treaty has not yet entered into force pending ratification by the respective parliaments. The treaty between Portugal and Mozambique is also awaiting ratification by the two parliaments and has not yet entered into force.

to grant relief from double taxation by way of an ordinary tax credit for the withholding tax in the source state.[14] For outbound dividends the general tax rates vary between 15% and 10%. In general, the Madeira regime is more favourable than those in bilateral treaties, despite other facilities such as the tax sparing credit clauses in tax treaties.[15]

IV. PARENT-SUBSIDIARY DIRECTIVE IMPLEMENTATION

A. General comments

The Parent-Subsidiary Directive was implemented by Decree-Law No. 132/92 of 2 July 1992 which amended the IRC Code. The amendments applied retroactively as of 1 January 1992.[16]

For inbound dividends Portugal adopted the rule under Article 4(1) first hyphen of the Parent-Subsidiary Directive. This provision reflected the exemption regime already existing in Portugal. Therefore, 95% of inbound dividends or profit distributions received by Portuguese parent companies from a qualifying EC resident subsidiary are exempt from IRC. To qualify as a parent, a company should hold directly at least 25% of the subsidiary's capital (under a bilateral agreement between two countries, at least 25% of the voting rights) for the previous two years or since the date of formation of the latter.

For outbound dividends the final withholding tax rate applicable to the payment of dividends to foreign parent companies has been reduced from 25% (when no treaties exist, i.e. in the case of the Netherlands, Greece and Luxembourg) to 15% in the period from 1992 to 1996, and to 10% in the period from 1997 to 1999. In the year 2000 the tax rate must be 0%. Nevertheless, when the distributor is a corporation (SA) the Portuguese authorities informally defend the position that the 5% flat rate which is a substitute for the inheritance and gift tax should also be withheld at source in addition to the dividend withholding tax. This tax is not applicable when the payor is a limited liability company (Lda).[17]

B. In Madeira Free Zone

The Parent-Subsidiary Directive also applies in Madeira because the island is part of Portugal's territory and is considered to be part of the European Community. Problems will certainly not arise for ordinary companies. But will the Parent-Subsidiary Directive be applicable to "Madeira Free Zone Companies" if Article 2(c) of the Directive is taken into consideration? This article states that a company must be "subject to IRC without the possibility of an option or of being exempt".

Companies incorporated or established in Madeira Free Zone may benefit from an exemption from the IRC regime as indicated above. This tax is not applicable when Madeira Free Zone companies pay dividends abroad or to SGPSs in mainland Portugal. However, there are several limitations and restrictions to this regime. In general, Portuguese dividends are not exempt in Madeira companies. In addition, in order to be exempt foreign dividends should derive from activities conducted "within the institutional ambit of the respective zone". The law does not specify what is meant by an activity developed "within the institutional ambit of the respective zone". For the time being, this "institutional ambit" is understood by the Madeira authorities and investors as the one resulting from the objectives of the company along with the specific licence granted by the Regional Government of Madeira after its evaluation of the investor's project.[18] This ambit is not defined as a geographical space but instead is assumed to be an offshore centre. In addition, companies nowadays are more protected *vis-à-vis* the Portuguese tax administration because exemptions are granted expressly to holding companies.

The exemption from IRC is therefore partial (some income is subject to IRC and other taxes), temporary (up to 2011) and objective. In fact, the exemption is granted automatically, taking into consideration the type of activity, but only applies to companies authorized to conduct their activities in the Zone. Moreover, in general, Madeira companies must pay other taxes (e.g. VAT, although at reduced rates) and must comply with many other tax obligations.

Thus, SGPSs undoubtedly qualify because they are subject to IRC regarding dividends received from Portuguese or EC sources. On the other hand, it would seem that Madeira mixed holding companies should also qualify for Parent-Subsidiary Directive purposes.

Taking in consideration the specific regime of Madeira applied to holdings, foreign dividends received by qualifying companies are exempt from IRC, whether the latter is considered as a parent company for the Parent-Subsidiary Directive purposes or not. This exemption also applies to dividends paid by third-country companies (e.g. Japan, the United States, Australia or Angola) to mixed or pure holdings. In addition, the payment of dividends (other than

14. See De Sousa da Câmara *supra* note 1.
15. See Kuiper, Willem G., "Madeira: Some International Tax Implications of the Madeira Free-Zone Legislation", 33 *European Taxation* 3 (1993), at 95.
16. General and specific comments can be found in *EC Corporate Tax Law*, Vol.I, Portugal – Part B, "Parent/Subsidiary Directive" (Amsterdam: IBFD) and in Portuguese, De Sousa da Câmara, Francisco: "O Regime fiscal comum aplicável às sociedades-mães e sociedade afiliada de diferentes estados-membros das comunidades europeias" – Commentary on Directive 90/435/EEC – *Fisco* No. 43/44, June 1992, at 40-58.
17. The author feels that the 15% or 10% mentioned in Article 5(4) of the Parent-Subsidiary Directive should be understood as the maximum limit as well as the 0% foreseen by Article 5(1). The Directive does not refer to corporate income tax but simply to "withholding" tax rate. Therefore, this rule would seem to be an "obligation of result".
Even before the Directive, the 5% seemed unconstitutional for two main reasons. First, because it intends to be a substitute inheritance and gift tax but companies do not die. Moreover, the inheritance and gift tax should be a progressive tax according to the Portuguese Constitution (Article 107(3)) and this tax rate is proportional. Second, because it allows form to prevail over substance in an intolerable manner. In effect, this 5% appears as a new tax on income given a fanciful name. If the Government policy prevails we may witness an absurd event in the year 2000: the corporate income tax will be reduced to 0%, but the substitute inheritance and gift tax may be raised up to 15%, 20% or (who knows) even more.
In the absence of knowing what was in all the Council's minutes it is difficult to guess what the end result of litigation against the Portuguese authorities would be. But even if all the other EC Member States agreed to the 5% surplus, the author thinks that the EC Court of Justice may decide in favour of the taxpayers because the Court is not bound by Council minutes but must interpret the Directive's provisions under Article 189 of the Treaty of Rome.
18. General opinion supports this, in particular a legal opinion rendered to SDM SA, by Professor Doutor Alberto Xavier, a well-known professor of taxation.

those deriving from the payment of Portuguese dividends) by Madeira companies to foreign companies is exempt from withholding tax.

Distributions within the territory of Portugal, including distributions to or from Madeira, do not benefit from the Madeira exemptions but from general domestic schemes such as the imputation tax credit system and the affiliation privilege. The consolidation regime is not applicable to Madeira because it requires that all companies be subject to, and not exempt from, IRC.

V. CONCLUSIONS

The existence of several domestic and international provisions regarding the treatment of inbound or outbound dividends paid to or by Madeira Free Zone companies mean that investors must pay special attention to them. This situation has arisen since the implementation of the Parent-Subsidiary Directive and, subsequently, because of the new treatment of pure holdings (SGPSs). In addition, the statement that Madeira tax benefits cannot be applicable to operations between residents has highlighted the issue. In general, residents of Portugal cannot buy shares in Madeira companies in order to benefit from the withholding tax exemption under the Madeira regime when those companies distribute dividends.

Portuguese companies may control or be controlled by "Madeira companies", but in general the "Madeira exemptions" are not applicable to their transactions. However, all other ordinary domestic regimes such as the imputation system or the affiliation privilege should apply.[19] The consolidation regime is not applicable because all profits must be subject to tax. In addition, the Portuguese shareholders of qualifying Madeira industrial companies may benefit from the exemption from IRC or IRS for dividends received from those companies.

Foreign quota or shareholders benefit from IRC or IRS exemption (in particular, from withholding tax) for all distributions made by mixed or pure holdings, provided that the income concerned is not derived from mainland Portugal. Thus, Madeira holding companies would appear to be important vehicles as intermediate conduit companies.

Mixed holdings recognized as international service companies are in general exempt from IRC for the dividends received in Madeira from EC or third-country companies, whatever the percentage of control or the period of control may be. In the author's opinion, these companies should also qualify for Parent-Subsidiary Directive purposes, provided that the necessary requirements are met.

Pure holdings (SGPSs) are subject to tax with respect to Portuguese and EC dividends, but the affiliation privilege applies. For domestic distributions it is not necessary to hold 25% of the voting rights during a period of two years in order to benefit from this regime, but these requirements must be met if dividends are paid by EC subsidiaries. Madeira's SGPSs are exempt from IRC with respect to dividends received from non-Portuguese or non-EC companies. Moreover, they can redistribute the foreign income from EC or non-EC companies as dividends without any withholding at source.

These companies may also benefit from the effects of Portuguese tax treaties on the lines indicated above. However, in spite of being very attractive from a tax point of view, the commercial constraints mentioned in II.A. should also be kept in mind.

Finally, for dividends received from companies based in mainland Portugal, Madeira SGPSs or mixed holdings may be tempted to reconvert that income into "interest" or "royalties" to be paid abroad without any withholding at source. Another technique often used to make remittances abroad without withholding tax is to reimburse shareholders for loans made previously to the company. In addition, the enormous advantages of the tax sparing clauses included in the majority of the treaties signed by Portugal cannot be ignored.

TABLE I – WITHHOLDING TAX RATES ON DIVIDENDS

To From (Portugal)[1]	B	Dk	Fr	Ge	Gr	Ir	It	Lux	Nl	Pt	Sp	UK	Ja	US
Normal Tax Rate	–	–	–	–	25	25	–	25	25	–	–	–	25	25
When PSD Applies	15	15	15	15	15	15	15	15	15	–	15	15	–	–
When Tax Treaties Apply	15	10	15	15	–	15	15	–	–	–	10	10	–	–
Stock Exchange	a)													
Privatized Companies	b)													
Madeira Free Zone	(2)	–	–	–	–	–	–	–	–	(3)	–	–	–	–

a) only 60% of the dividends distributed are considered taxable income.
b) only 60% of the dividends distributed are considered taxable income.
(1) An additional 5% substitute inheritance and gift tax applies for distributions made by corporations (SA), except when the recipient is a SGPS or, in the author's opinion, when the Parent-Subsidiary Directive is applicable.
(2) The general withholding tax rates are applicable when dividends distributed correspond to income obtained in Portugal.
(3) The income is subject to tax in Portugal but it can benefit from the Portuguese domestic tax regime to reduce double taxation.

TABLE II – WITHHOLDING TAX RATES ON DIVIDENDS

To	*Mainland Portugal*			
From (M.F.Zone)	Individual	Company	Mixed Holding Company	SGPS
SGPS	25%(1)	25%(2)	–(3)	–(3)
Mixed Holding	25%(1)	25%(2)	–(3)	–(3)

(1) Final tax unless recipient elects to treat it as a payment on account.
(2) Payment on account, final tax rate is 36% plus the municipal surcharge (3.6%).
(3) No withholding tax. In the author's opinion, the affiliation privilege also applies in mainland Portugal.

19. Under the current imputation tax credit system, resident companies may credit 50% of the underlying corporation tax relating to those dividends against their corporate income tax. According to a clarification issued by the tax authorities the effective tax on the dividends received is 28%.
The affiliation privilege is explained *supra* in the text. The consolidation regime to avoid double taxation is not applicable because all profits of companies are subject to IRC.

TABLE III –
WITHHOLDING TAX RATES ON DIVIDENDS

To	Holdings in Madeira Free Zone	
From	SGPS	Mixed Holding
Mainland Portugal	–[1]	–[2]

(1)(2): No withholding tax is applicable under Article 76(c) IRC, but those companies will be subject to tax in Madeira and must include the dividends received from the Portuguese subsidiary in their taxable income (Article 41(g)(h) EBF). The affiliation privilege is applicable, but the general withholding tax rates are applicable when dividends corresponding to that income are redistributed abroad.

DIAGRAM I

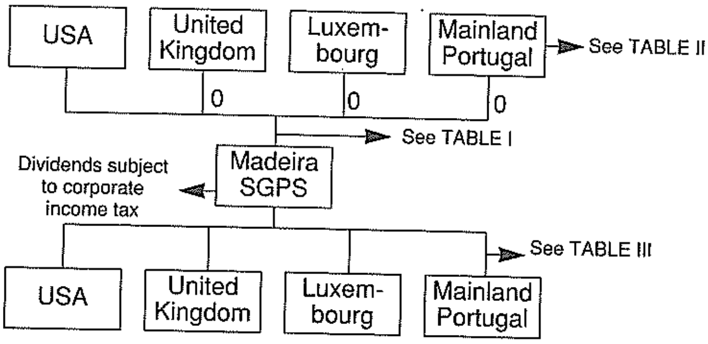

DIAGRAM II