

tion. Shipowners, save when insolvent, may commence depreciation of such ships as soon as expenses of at least 10 per cent of their contractual value are incurred. That constitutes a major derogation from the usual rule that depreciation may be executed only after the fixed assets have been transferred for exploitation.<sup>63</sup> Several concerns are raised by numerous exemptions as well as the lengthy inventories of non-deductible costs, spread across CIT and PIT Act.

## 9. Concluding remarks

This overall presentation was intended to present selected issues of Polish direct taxation likely to be

affected by Polish accession rather than provide an exhausting compliance analysis. Whereas certain vital shortcomings or doubts were addressed, only the practice of the coming years, with domestic tax system being exposed to administrative and judicial review of national and Community courts, will reveal the areas of concern and dispute.

<sup>63</sup> It must be noted, however, that such aid may fall under special rules of the Community guidelines on state aid to maritime transport, OJ, C 205 of 05 July 1997.

# The Madeira Free Zone and its standpoint within the European Union



**Fernando Brás, Tax Partner, Ernst & Young, Lisbon, Portugal**

**Patrick Dewerbe, Tax Manager, Ernst & Young**

**Ricardo Borges, Teaching Assistant, Lisbon University School of Law, Portugal\***

## 1. Introduction

In this article we attempt to summarize the recent and complex evolution of the Madeira Free Zone (MFZ) - or the Madeira International Business Centre (MIBC), the more trendy and fashionable designation - regime within the EU, to report its latest developments, and to point out opportunities, trends and challenges.<sup>1</sup> Our aim is therefore more descriptive and prospective than theoretical.

The MFZ consists of four areas:

- (1) International Shipping Register,
- (2) Industrial Free Trade Zone,
- (3) Financial Services Centre, and
- (4) International Services Centre.

Our focus will be on the latter, which is both the most important and contentious. We do not attempt to deal with the larger issue of the OECD harmful tax competition debate and its implications for the MFZ.<sup>2</sup> Nevertheless, we note that, in part due to

Text distributed at the Conference *As Praças Internacionais de Negócios no Contexto da Economia Global - O Caso do Centro Internacional de Negócios da Madeira* (The International Business Centres in the Context of the Global Economy - The Case of the Madeira International Business Centre), held in Funchal on 30 and 31 January 2003, AAVV (2003) (org. SDM), *Dossier Técnico (Technical Dossier)*, pp. 131-161, 'A Fiscalidade das "Praças Internacionais de Negócios" na Óptica da União Europeia', *Fisco*, Ano XV, no. 111-2 (January 2004), pp. 31-59; 'Point J of the Code of Conduct or the Primacy of Politics over Administration', *European Taxation*, September 2000, vol. 40, no. 9, pp. 417-421; Clotilde Celorico Palma, 'A Concorrência Fiscal sob Vigilância: Código de Conduta Comunitário da Fiscalidade das Empresas versus Relatório da OCDE sobre as Práticas da Concorrência Fiscal Prejudicial, *Revisores e Empresas*, January-March 1999, no. 4, pp. 5-20; 'O combate à concorrência fiscal prejudicial - Algumas reflexões sobre o Código de Conduta comunitário da Fiscalidade das Empresas', *Fiscália*, September 1999, no. 21, pp. 4-13; Diogo Ortigão Ramos, 'Madeira: Harmful Tax Regime or Compatible State Aid?', *International Business Lawyer*, September 2000, vol. 28, no. 8, pp. 350-351; Manuel Henrique de Freitas Pereira, 'Concorrência fiscal prejudicial - o código de conduta da União Europeia' *Ciência e Técnica Fiscal*, April-June 1998), pp. 205-219, 'Concorrência fiscal prejudicial - o código de conduta da União Europeia', AAVV (2000) (org. António Marcos), *I Congresso Internacional de Direito Fiscal - A Fiscalidade na União Europeia. Presente e Futuro* (Edições Universidade Fernando Pessoa, Porto), pp. 131-145. Recently see António Carlos dos Santos (2003), *Auxílios de Estado e Fiscalidade* (Livraria Almedina, Coimbra).

<sup>2</sup> On the MFZ towards OECD issues, see Clotilde Celorico Palma, 'A OCDE e o Combate às Práticas da Concorrência Fiscal Prejudicial: Ponto de Situação e Perspectivas de Evolução', text distributed at the Conference *As Praças Internacionais de Negócios no Contexto da Economia Global - O Caso do Centro Internacional*

\* The authors have worked jointly at a number of Madeira Free Zone issues and have partly based this article in a previous tax opinion. They would like to thank Ms. Clotilde Celorico Palma for her helpful comments on a draft version of the article. She is neither bound by our opinions nor responsible for any mistakes or omissions herein.

<sup>1</sup> On the MFZ towards EU issues see António Carlos dos Santos, 'A Fiscalidade das Praças de Negócios na Óptica da União Europeia',

the influence of the relevant EU developments,<sup>3</sup> all the features of the MFZ regime that had been *prima facie* qualified as potentially harmful have now been considered as abolished (insurance, fund managers, banking, headquarters regimes,<sup>4</sup> shipping) or even not harmful (shipping) by the OECD June 2003 Progress Report on Harmful Tax Competition (table attached to point 11). As point 12 of this Report states:

'The Committee decided that where a regime is in the process of being eliminated, it shall be treated as abolished ... if (1) no new entrants are permitted into the regime, (2) a definite date for complete abolition of the regime has been announced, and (3) the regime is transparent and has effective exchange of information. ... Portugal's Madeira International Business Centre ... regimes are treated as abolished on this basis.'<sup>5</sup>

Therefore, and in spite of this wording, the safeguarding of the (then) existing regime for those that were admitted to it has been assured up to 2011.

The analysis of the MFZ regime *vis-à-vis* the EU must be done taking into account two different fields of analysis: the state aid regime and the Code of Conduct rules. State aid consists of a special regime established by the EC Treaty - currently under Art. 88 and previously under Art. 92 - that allows the Member States to grant tax exemptions or financial incentives under the scrutiny of the European Commission. Among other objectives, it is aimed at promoting the economic development of certain underdeveloped zones of the EU (Art. 87, para. (3)(a) of the EC Treaty).

Following two years of work and discussions, initiated by the EU back in the Ecofin meeting of 1 December 1997, with the objective of dealing with measures that provide for a significant effective level of lower taxation by means of a Code of Conduct for Business Taxation,<sup>6</sup> the homonymous (or Primarolo) Group issued on 23 November 1999 (27.11), a report to the Ecofin of 29 November 1999,<sup>7</sup> listing the EU Member States measures that were considered harmful from a tax perspective.<sup>8</sup> One year later, the Ecofin of 29 November 2000, reached an interim agreement on the guidelines to assist the Member States on standstill and rollback, regarding the measures that were considered harmful in the areas of finance branches, holding companies and headquarters companies.<sup>9</sup>

Therefore, under the state aid regime, the Commission approves certain measures that are considered beneficial to development, thus allowing the Member States to grant financial and tax incentives. Under the so-called Code of Conduct evaluation, this Group lists certain measures that are considered harmful, thus compelling the Member States to put an end to them, adopting a standstill and rollback attitude.

## 2. The state aid regime

### 2.1. Overview

Following the admission of Portugal to the EC, the former was allowed, under the state aid regime, to

maintain special tax incentives for the MFZ.<sup>10</sup> Entities licensed until the end of the year 2000 were allowed to benefit, among others, from a corporate income tax (IRC) exemption until the end of the year 2011. This decision was taken in 1987, for an initial period of five

*cont.*

*de Negócios da Madeira* (The International Business Centres in the Context of the Global Economy - The Case of the Madeira International Business Centre), held in Funchal on 30 and 31 January 2003, AAVV (org. SDM), *Dossier Técnico (Technical Dossier)*, pp. 99-130; 'A OCDE e os paraísos fiscais: novas formas de discriminação fiscal?', *Revista TOC*, July 2001, no. 16, pp. 22-29; 'A OCDE, a Concorrência Fiscal Prejudicial e os Paraísos Fiscais: Novas Formas de Discriminação Fiscal?', *Ciência e Técnica Fiscal*, July to September 2001, no. 403, pp. 147-171. Recently see Clotilde Celorico Palma, 'A OCDE e o Combate às Práticas da Concorrência Fiscal Prejudicial: Ponto de Situação e Perspectivas de Evolução', *Fiscalidade* (October 2003, no. 16, pp. 49-79).

<sup>3</sup> On the MFZ towards both EU and OECD issues, see António Carlos dos Santos, 'Constrangimentos internacionais ao recurso a medidas fiscais para melhorar a competitividade', pp. 3-8, text distributed at the Conference *O Centro Internacional de Negócios da Madeira - Presente e Futuro* (The Madeira International Business Centre - Present and Future), held in Lisbon on 23 June 2003; 'A posição portuguesa face à concorrência fiscal', text distributed at the Conference on *Planeamento e Concorrência Fiscal Internacional* (International Tax Planning and Competition) held in Lisbon on 7 and 8 March 2002, AAVV (2003) (org. Associação Portuguesa de Consultores Fiscais/Fisco), *Planeamento e Concorrência Fiscal Internacional* (Lex, Lisboa), pp. 153-190; and 'Concorrência fiscal: qual e como', *Diário de Notícias (Empresas)* October 2001; Clotilde Celorico Palma, 'O Novo Regime Fiscal do Centro Internacional de Negócios da Madeira - Enquadramento e Características Fundamentais', *Fisco*, January to March 2003, Ano XIV, no. 107-8, pp. 55-79; 'Aspectos Principais do Novo Regime de Incentivos', text distributed at the Conference *O Centro Internacional de Negócios da Madeira - Presente e Futuro* (The Madeira International Business Centre - Present and Future), held in Lisbon on 23 June 2003; Clotilde Celorico Palma, 'Novo Regime Fiscal do Centro Internacional de Negócios da Madeira', *Revista TOC*, September 2003, no. 42, pp. 22-27; Clotilde Celorico Palma/António Carlos dos Santos, 'A regulação internacional da concorrência fiscal prejudicial', *Ciência e Técnica Fiscal*, July to September 1999, no. 395, pp. 7-36.

<sup>4</sup> We have some difficulty in understanding this designation in the context of the MFZ as there is no specific coordination regime therein. See 2.3. and 3. below for discussion of a similar problem with regard to the EU developments.

<sup>5</sup> This Report is not officially published or available at the OECD website and we have used a draft version. Therefore the accuracy of the quotation *vis-à-vis* the final version of the Report cannot be guaranteed.

<sup>6</sup> See the Annex to the 'Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy - Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation', OJ, C 2, 6 January 1998, pp. 1-6.

<sup>7</sup> At its session of 28 February 2000 the Council decided to make this report accessible to the public without taking any position on its content. See '2245th Council meeting - ECOFIN - Brussels, 28 February 2000', 6450/00 (PRES/00/49). This publication was made through SN 4901/99, Brussels, 29 February 2000.

<sup>8</sup> Both the Code of Conduct and the Primarolo Report are published in Portuguese in the *Cadernos de Ciência e Técnica Fiscal* no. 185, 2000. These *cahiers* are the official publication series of the Centre of Tax Studies of the Ministry of Finance.

<sup>9</sup> On this, see Heleen Nijkamp, 'Landmark agreement on EU tax package: new guidelines stretch scope of EU Code of Conduct' in *EC Tax Review* 2001, vol. 10, no. 3, pp. 147-154.

<sup>10</sup> State aid regime no. 204/86 granted to Portugal by the letter SG (87) D/6736, of 27 May 1987, which allowed the regime for an initial period of five years.

years, and renewed twice, in 1992<sup>11</sup> and 1995,<sup>12</sup> for additional periods of three and five years, thus allowing Portugal to maintain the MFZ regime available for the entities entering it until the end of the year 2000.

Further to the Ecofin of 1 December 1997, the Commission adopted restrictive guidelines on regional state aid.<sup>13</sup> Nonetheless, an exception was foreseen for regions qualifying for derogation under Art. 87, para. (3)(a) of the EC Treaty provided that:

- (i) the aid was justified due to its nature and contribution to regional development, and
- (ii) the level of the aid was proportional to the handicaps it was intended to deal with.

In this context, on 24 February 1998, the Commission, due to the Financial Services Centre, required Portugal to change the existing MFZ regime, something that did not happen.<sup>14</sup> Therefore, on 17 July 2000, the Commission announced the decision of investigating the MFZ regime and took the view that 'the aid granted from January 1, 2000 onwards', under the then-existent and previously approved MFZ regime, might be qualified as illegal and become recoverable from its beneficiaries.<sup>15</sup> Licenses issued by the Madeira Development Company (*Sociedade de Desenvolvimento da Madeira* (SDM)), the entity that manages the free zone, during the year 2000, mention this and say the license is granted notwithstanding the possible (retroactive) liability to the new tax regime to be determined by the EU. During the months of July to September 2000 the issuing of new licenses was even suspended by the SDM. As far as our knowledge goes, however, no licenses for entry into the Financial Services Centre were issued during the year 2000.

Meanwhile, at the end of the year 2000, Portugal approved a new regime applicable for entities licensed in the MFZ after 2001, which still included the possibility of new entrants in the Financial Services Centre.<sup>16</sup> Since the changes were introduced to be effective as from 1 January 2001, the initial term of the state aid set by the Commission back in 1995 - instead of 1 January 2000, as requested subsequently by this body in 1998 - the EU challenge covering the year 2000 remained. This new regime provided for low IRC rates, instead of the previous exemption regime, but never entered into force. Indeed, new licenses would only be issued once Portugal received the approval of this post-2001 regime from the Commission. According to press information of 26 April 2001, the Commission made clear that it would not approve the new regime until an inquiry was taken on the conditions under which the MFZ was currently functioning.

In conclusion, there were two procedures: one regarding 'aid granted from January 1, 2000 onwards' (existing regime); another concerning the new state aid regime requested by Portugal for 2001 onwards (to be enacted regime).

## 2.2. The status of 1999 and 2000-licensed companies

### 2.2.1. *The meaning of 'aid granted from January 1, 2000 onwards'*

In view of the above, we would like to comment on the Commission challenge, and particularly on the likelihood that 1999-licensed companies might be deemed not to qualify for the existing IRC exemption.

The use of the expression 'aid granted from January 1, 2000 onwards' used by the Commission was unclear and could, in theory, be understood as meaning that the tax incentives obtained from 1 January 2000 onwards might be questioned for entities licensed to operate within MFZ:

- (i) even if they were incorporated before 1 January 2000;
- (ii) before 1 January 2000 but only insofar as they were incorporated or legally set therein after that date;
- (iii) after 1 January 2000 (and consequently incorporated or legally set therein).

The position set in (i) was not clearly argued by any commentator, not even the Commission.<sup>17</sup>

<sup>11</sup> State aid regime E 13/91 granted to Portugal by the letter SG (92) D/1118, of 27 January 1992, which renewed the approval for an additional period of three years.

<sup>12</sup> State aid regime E 19/94 granted to Portugal by the letter SG (95) D/1287, of 3 February 1995, which renewed the regime for an additional period of five years.

<sup>13</sup> See 'Guidelines on national regional aid' (98/C 74/06), OJ, C 74 of 10 March 1998, pp. 9-31, 'Commission notice on the application of the State aid rules to measures relating to direct business taxation' (98/C 384/03), OJ, C 384, of 10 December 1998, pp. 3-9, and 'Amendments to the Guidelines on national regional aid' (2000/C 258/06), OJ, C 258, of 9 September 2000, p. 5.

<sup>14</sup> Partial and full account of the procedures relating to this matter are summarized, respectively, in 'State aid - Invitation to submit comments pursuant to Article 88(2) of the EC Treaty concerning aid C 37/2000 (ex NN 60/2000, ex E 19/94, ex E 13/91 and N 204/86) - Financial and tax aid scheme for the free zone of Madeira (Portugal)', OJ, C 301, of 21 October 2000, pp. 4-12, and in the 'Commission Decision of December 11, 2002, on the application by Portugal of the financial and tax aid scheme for the free zone of Madeira in the period between 1 January and 31 December 2000' (notified under document number C(2002) 4825), OJ, L 111, of 6 May 2003, pp. 45-49. See point 1, p. 45.

<sup>15</sup> See 'European Union - European Commission to investigate financial and tax aid scheme for Madeira free zone', *Tax News Service*, August 2000, vol. 34, issue 32, pp. 295-296. See also point 5 of the 'Commission Decision of December 11, 2002, on the application by Portugal of the financial and tax aid scheme for the free zone of Madeira in the period between 1 January and 31 December 2000', p. 46.

<sup>16</sup> Law no. 30-F/2000, of 29 December 2000. See 'Portugal - new tax scheme for Madeira and Santa Maria (Azores) free zones implemented - clarification', *Tax News Service*, 19 March 2001, vol. 35, issue 12, p. 153, and 'Portugal - new tax scheme for Madeira and Santa Maria (Azores) free zones implemented', *Tax News Service*, 5 February 2001, vol. 35, issue 6, pp. 76-77.

<sup>17</sup> Another more demanding position (iv) might say that 'settlement' in Madeira qualifying entities for the IRC exemption would be the beginning of activities and the engagement of a material and human structure there. However, this last 'substance' criterion has never been applied in practice, to our knowledge, and only the formal 'license' and 'incorporation/legally setting' criteria have been discussed in this regard.

From an IRC and legal perspective, MFZ, as Portuguese companies, are active as from the year of their incorporation, or even before that (the commencement of activity, as declared for tax purposes, may take place by an irregular company prior to the notary public deed or the commercial registry). These companies, even with none or few activities, have complied with all tax and legal obligations on a yearly basis. Those obligations include the filing of annual tax returns, the approval of annual accounts, and the payment of initial and on-going license fees. The tax incentives will be available as from the year where the license is valid regardless of the effective start date of the company's activity. According with MFZ commercial, administrative and tax law, those incentives will only be cancelled if the entities do not comply with the obligations imposed upon them, which basically involve the payment of annual license fees, the respect of the licensed activity/social object, and the fulfilment of tax returns and other legal obligations. Under the terms of the 1995 state aid approval there were no requirements regarding the extent of the activity that these companies should carry on. The issue of implementation or settlement had never been raised either by Portugal or the Commission in its contacts with the former.

The fact that licenses are sometimes issued for nominee companies and the fact that nominee shareholders incorporate shelf companies whose shares are transferred later may not seem at first a very transparent practice. However, we note that the legislation specifically allows management companies or lawyers to apply for 'shelf licenses' on the account of companies to be incorporated. Additionally, this procedure was not initiated with the current EU challenge. It was set up as a way of speeding up the incorporation of Portuguese companies. In the early 1990s a company might take up to six months to be incorporated. Currently, it is normal for the setting of a company to take two months. Therefore, in order to allow clients to start operating immediately, since the beginnings of the MFZ back in 1986 there have been 'ready-to-use' companies, whose shares are subsequently transferred (with the underlying procedures at the public notary and the commercial registry, when due) upon client's decisions.

According to the SDM's view, 'aid granted from January 1, 2000 onwards' should be understood as meaning that the tax incentives of the MFZ might only be denied under the position set in (iii) to entities licensed to operate therein from 1 January 2000 onwards.<sup>18</sup>

On 14 December 2000, the Madeira Regional Government issued an order revoking the safeguard clause stated in the MFZ licenses issued during the year 2000, informing SDM, requesting this entity to communicate that fact to the holders of the licenses, and stating that the new licenses to be issued should not contain any safeguard clause.<sup>19</sup> This reinforced the view that the Portuguese authorities - namely the Madeira Regional Government, the entity that was most directly affected by the Commission challenge - believed that 1999-licensed companies were under the scope of the state aid regime as approved in 1995.

Additionally, as far as our information goes, other EU countries did not object, under the procedure initiated by the Commission against Portugal, that entities licensed to operate in the MFZ until the end of 2000 qualified for the tax holiday.<sup>20</sup> In other words, for companies duly licensed until 31 December 1999, the common understanding was that the pre-2001 MFZ regime could not be questioned. Companies with licenses issued prior to 31 December 1999, should thus benefit from the IRC exemptions until 31 December 2011, while companies with their licenses issued afterwards should be subject to the new regime.

The most controversial question was what would happen with the companies having their licenses granted during 2000. According to the tax opinions of numerous legal experts, 2000-licensed companies should still enjoy from the exiting tax holiday, since those were the terms of the initial EU state aid and the Portuguese Constitution does not allow for retrospective legislation. These two facts, which are developed below, also provided support for the idea that 1999-licensed companies should qualify for the current IRC exemption.

### 2.2.2. European Commission 1995 state aid decision

This decision enabled entities 'settled' until 31 December 2000, as mentioned, to enjoy from the existing MFZ tax regime. Again, no definition of 'settlement' existed. However, it was argued that given that this type of conditioned and temporary tax incentives functions like a 'tacit agreement' between the taxpayer and the state, the relevant moment for the formation of that 'contract' was the moment where the taxpayer was granted the license to operate in the MFZ.

In this regard, one can say that since licenses issued in the year 1999 did not have any safeguard clause, and that the procedure of the Commission was made against Portugal, there was no direct knowledge or effect of that procedure by or towards the taxpayers licensed to operate in the MFZ in the mentioned year.

There were therefore good grounds to sustain that the economic operators had legitimate expectations, when they licensed entities in 1999, of being under the scope of the EU state aid decision taken by the Commission in 1995.

The fact that under 1998 guidelines on national regional aid the Commission superseded its prior decision and required Portugal to amend the MFZ tax

<sup>18</sup> SDM, Editorial, *Boletim Informativo*, May to June 2003, p. 2; *Circular sobre deliberações da Comissão Europeia respeitantes ao Centro Internacional de Negócios da Madeira*, 12 December 2002; *Circular sobre 'Procedimento de investigação' decidido pela Comissão Europeia sobre a Zona Franca ou Centro Internacional de Negócios da Madeira (CINM)*, 11 October 2000.

<sup>19</sup> Secretário Regional do Plano e Finanças do Governo Regional da Região Autónoma da Madeira (2000), *Ofício (SAI 002/00/SRP) dirigido ao Presidente da SDM*, 14 December 2000.

<sup>20</sup> See point 18, of the 'Commission Decision of December 11, 2002, on the application by Portugal of the financial and tax aid scheme for the free zone of Madeira in the period between 1 January and 31 December 2000', p. 48.

regime from 1 January 2000, onwards might not be sufficient to grant it a direct claim against the taxpayers. This was no longer true for licenses issued by the SDM during the year 2000, since those borne the said safeguard clause, even though the Madeira Regional Government has revoked the latter. This procedure by the Portuguese authorities might not create legitimate trust and expectations for the beneficiaries under the ECJ jurisprudence and from a EU standpoint, as this requires compliance with the EC Treaty due process. Nevertheless, such behaviour by the Portuguese authorities might render it responsible towards the beneficiaries for having created legitimate expectations, but only from a national point of view.

Additionally, according to EU law,<sup>21</sup> the recovery of tax incentives eventually granted in an illegal form from their beneficiaries would be made according to the Portuguese procedure law. Given that Portugal was fighting the Commission, it was highly unlikely that this last entity would in any circumstance be able to recover through the use of Portuguese procedure law or Portuguese courts any tax incentives from the final beneficiaries. We note that, in practice, only Portugal was in the position to know who the beneficiaries of the state aid had been.

### 2.2.3. Portuguese Constitution prohibition of retroactive tax law

In practice, any change in the MFZ tax regime has to be taken by an amendment to Art. 33 (formerly Art. 41) of the Tax Incentives Statute (*Estatuto dos Benefícios Fiscais* - EBF), which requires a parliament law or a government authorized decree law.

Recognizing the need of adapting the MFZ regime to the EU requirements on the subject, and following a first notification for the proposed amendment of the regime by Portugal in December 2000, the Government enacted changes to the incentives granted to companies licensed in the MFZ in 2001.<sup>22</sup> The Government has elected the moment of issuing of the license as the relevant one for the application of the new regime.

This 'license date criterion' further reinforced the idea that companies licensed before 31 December 2000, in general, and before 31 December 1999, in particular, would remain subject to the exemption regime enforced until 31 December 2000, although the Commission still had to conclude the procedures regarding 'aid granted from January 1, 2000, onwards'. Confirmation of this new regime remained therefore to be determined after the outcome of the Commission review on the MFZ.

Consequently, the enforcement of any Commission approved change with effects starting on 1 January 2000, onwards in the MFZ tax regime would require the cooperation of the Portuguese authorities to enact a new law, or to amend the existing regime to cover '2000 situations', and this was politically unrealistic in the light of the position taken by the Portuguese Government, and due to the fact that Madeira has a strong Regional and autonomous Government which would not accept such behaviour by the mainland authorities.

Finally, even if this law was enacted, it would most certainly be regarded as unconstitutional, given that it would be published after the date of the IRC triggering event (the moment the income is obtained). Accordingly, taxpayers would have some legal support not to comply with any demand towards the payment of taxes with regard to 1999-licensed companies already incorporated and operating in the year 2000. Nevertheless, according to Council Regulation no. 659/1999, of 22 March 1999, and from an EU strict point of view, the recovery of tax incentives eventually granted in an illegal form from their beneficiaries would still be possible. In spite of the principle of primacy of EC law over national law, the potential clash between the enforcement of a community regulation and a national Constitution would legitimately generate much debate.

Two years - 2001 and 2002 - elapsed and the legally envisaged EBF regime for that period lived only in the black letter of the law, as the issuing of licenses remained frozen. It became evident that the Commission would not accept the first notification, and Portugal filed a second notification on March 2002 that departed from the previous one and from its EBF translation, conceding to some of the Commission demands.

Therefore the standpoint of the MFZ towards the state aid regime was as follows.

- Entities licensed until the end of 1999 were entitled to benefit from the MFZ exemption regime until the end of the year 2011, pursuant to the Commission decisions taken in 1987, 1992 and 1995.
- Entities licensed during the year 2000 should also be entitled to benefit from the MFZ exemption regime until the end of the year 2011. However, the Commission would have to confirm that the exemption regime would be extended to the entities licensed in 2000.
- Regarding 2001 onwards, the MFZ authorities were waiting for the Commission approval of a post-2001 state aid regime to start issuing new licenses.

### 2.3. European Commission 11 December 2002, press release

The negotiations between Portugal and the Commission on the two procedures (existing regime on 'aid granted from January 1, 2000, onwards'; new state aid regime to be enacted for post-2001) continued and a compromise based on the last notification was obtained, even though it involved still further resignation by the Portuguese authorities. Nevertheless, the factors highlighted above made a strong case for the 1999 and 2000-licensed companies. After Monti's 2002 loss in the procedure against Gibraltar,<sup>23</sup>

<sup>21</sup> Council Regulation (EC) no. 659/1999 of 22 March 1999, laying down detailed rules for the application of Art. 93 of the EC Treaty. OJ, L 83, 27 March 1999, pp. 1-9.

<sup>22</sup> See n. 16 above.

<sup>23</sup> See Joined Cases T-195/01 and T-207/01, of 30 April 2002, at <http://europa.eu.int/cj/index.htm>.

Portugal considered resorting to the ECJ to put an end to the 'aid granted from January 1, 2000, onwards' procedure. The fact that the Commissioner would not dare loosing his face again taking a long shot with very muddy legal artillery, may have helped reaching a global compromise on both procedures.

The end of both procedures<sup>24</sup> is summarized in press release IP/02/1849, of 11 December 2002, and titled 'Commission authorises tax reductions for the free zone of Madeira (Portugal)'.<sup>25</sup> Some of its points deserve being highlighted. First of all, the single most important sentence of the press release is the first: 'The previous scheme authorised by the Commission expired on 31 December 2000 ...'. It represents the only reference - feeble though it is - to the 'aid granted from January 1, 2000, onwards' procedure. In such a sentence the Commission, without much ado, conveys the idea that it too, in the end, acknowledges that the state aid regime approved in 1995 ended in 31 December 2000. And therefore, with this self-restrained and elliptical wording, it discreetly closed the investigation procedure relating to the year 2000.<sup>26</sup>

With regard to the new state aid regime for post-2001 it becomes evident that Portugal gave away the

which ranges from EUR 1.5 million (where less than three new jobs are created) to EUR 125 million (where more than 100 new jobs are created). The companies involved will have to start business within a fixed time limit (six months in the case of international services and one year in the case of industrial activities), or else the new licences granted in the free zone will no longer be valid.

Access to the international services centre is also restricted to the activities included in the list drawn up by the Portuguese authorities on the basis of the statistical classification of economic activities in the European Community (NACE Rev. 1.1). This list includes services supplied to agriculture, forestry and fisheries, the motor trade including wholesale, transport and communications, real estate, renting and services to business, higher education and adult education, recreational, cultural and sporting activities and personal services. However, the list explicitly excludes all financial and insurance intermediary activities, financial and insurance auxiliary activities and all "intra-group services" (coordination, accounting and distribution centres).

In its decision, the Commission particularly notes that the aid will be granted in an outermost region which is one of the least developed in the Union, and is aimed at promoting the establishment of activities which at present play little or no part in the region's economy. Given that activities which would contribute very little to the development of the region compared with the possible amount of aid (i.e. financial services and "intra-group" services) are excluded from the scheme, and that activities with a greater local impact (such as industrial activities and those which will lead to more job creation) are given priority, the Commission felt that the aid was likely to make a proportional contribution to the economic diversification of the region, and therefore to offset the additional costs of carrying on business which arise from the factors outlined in Article 299(2) of the Treaty (remoteness, insularity, small size, difficult topography and climate and economic dependence on a few products).

The Commission therefore considers that the aid will be granted in accordance with the conditions laid down in the guidelines on national regional aid with regard to operating aid, and thus meets the conditions necessary for it to be considered compatible with the common market under the derogation set out in Article 87(3)(a) of the Treaty.'

<sup>24</sup> Concerning the MFZ 2003-2006 state aid regime see the letter of the Commission to Portugal as state aid no. 222/A/02 (Industrial Free Zone and International Services), Brussels, 11 December 2002, C(2002) 4811/fin, at [http://www.europa.eu.int/comm/secretariat\\_general/sgb/state\\_aids/comp-2002/n222-a-02.pdf](http://www.europa.eu.int/comm/secretariat_general/sgb/state_aids/comp-2002/n222-a-02.pdf) and the 'Authorisation for State aid pursuant to Articles 87 and 88 of the EC Treaty - Cases where the Commission raises no objections', OJ, C 148, of 26 May 2003, p. 7 (state aid no. 222/B/02 - International Shipping Registry - MAR). See also the 'Commission Decision of December 11, 2002, on the application by Portugal of the financial and tax aid scheme for the free zone of Madeira in the period between 1 January and 31 December 2000'.

<sup>25</sup> 'The European Commission has authorised a new aid scheme for companies setting up in the industrial free zone and the international services centre of the free zone of Madeira over the period 2003-2006. In its decision, the Commission finds that the aid, granted in the form of tax reductions up to the end of 2011, could contribute to the economic diversification of the region. The aid should also compensate for the handicaps brought about by the region's dependence on a small number of sectors (such as tourism and public works).

The previous scheme authorised by the Commission expired on 31 December 2000 and was suspended by the Portuguese authorities in 2001 and 2002. The Commission decision therefore concerns the creation of a new aid scheme for the free zone of Madeira for the period 2003-2006. The free zone will now comprise an industrial free zone, an international services centre and an international shipping register, and the new companies which will be licensed to carry on business there between 1 January 2003 and 31 December 2006 will be able to enjoy a reduced rate of tax of 1% in 2003-2004, 2% in 2005-2006 and 3% in 2007-2011 (instead of the normal rate, currently 30%). As certain aspects concerning application of the scheme to the international shipping register still have to be clarified, that part of the free zone scheme will be the subject of a separate Commission decision.

Access to the scheme will be restricted to companies which meet the specific eligibility criteria, based on the number of new, permanent jobs created. Companies that create more than five jobs will have access to the scheme without further conditions, while those that create between one and five jobs will be eligible only if they make a minimum investment of EUR 75 000 during the first two years of business. In all cases, the tax benefits will nonetheless be limited by the ceiling placed on the tax base

<sup>26</sup> On points 21 and 22 of the 'Commission Decision of December 11, 2002, on the application by Portugal of the financial and tax aid scheme for the free zone of Madeira in the period between 1 January and 31 December 2000', p. 48, there is a little more development: '21. ... the Commission nevertheless has to acknowledge that the Portuguese authorities never explicitly notified it of their unconditional acceptance of the appropriate measures transmitted by letter SG(98) D/1684 of 24 February 1998 [regarding guidelines on regional State aid]. The Commission is therefore not able to refute the comments submitted by the Portuguese authorities under the formal investigation procedure, according to which such acceptance was never given. Under these circumstances the procedure initiated in respect of Portugal's non-compliance with the appropriate measures proposed by the Commission with regard to the application of the financial and tax aid scheme in the free zone of Madeira in the period between 1 January and 31 December 2000 no longer serves any useful purpose. 22. The Commission also notes that the aid scheme for the free zone of Madeira expired on 31 December 2000. ... 23. ... The Commission regrets, however, that the Portuguese authorities did not inform it in good time that they did not accept its proposal for appropriate measures pursuant to Article 88(1) of the Treaty as regards national regional aid, contrary to what would appear to be required by the principle of fair cooperation underlying the aforesaid Article 88(1).' Being independent observers, we believe that it is highly unrealistic for the Commission trying to make the public believe that, in the end, there was just a slight misunderstanding and that a 'debate between two deaf people' went on between 1998 and 2002. It seems more likely to view these statements as just a formal excuse for giving up a procedure that should not have been initiated in the first place and that was politically motivated, trying to set the MFZ as a trial ground for the Commission new approach on the harmful tax competition issue.

entrance of new entities in the financial services sector of the MIBC in exchange for the continuation of the MFZ. In our opinion, although this is still discriminatory towards the MFZ when compared to other regimes, as pointed out by Mr. Francisco Costa, the President of SDM and long-time master-minder of the MIBC,<sup>27</sup> it was not a great loss. The relationship between the Portuguese Government and the financial services sector of the MIBC has been very complicated from the upstart, as most of those operating therein are branches of the Portuguese mainland financial entities. The latter daringly - if not abusively - took advantage of the MFZ regime since its inception to exempt, in practice, all their foreign source income. There has been constant litigation in the tax courts and administrative cabinets between the Portuguese tax authorities and the mainland banks, and the Government-financial sector relationship is a source of constant headaches for the Ministers of Finance as it is under fire from the parliamentary oppositions and under scrutiny for the press. The financial services sector is not the main competitive advantage of the MFZ and in a certain sense we even believe that the Portuguese Government secretly desired to end the bad publicity that the sector generates on this issue.

There is a consistent emphasis of this new state aid regime on substance issues:

- (i) job creation;
- (ii) proportionate tax incentives to job creation by means of a climbing scale/cap;
- (iii) shelf-licenses;
- (iv) 'intra-group services' (coordination, accounting and distribution centres).

Before expanding on these issues, we note that substance is also a concern for 'new economy' investors that have been inflowing to the MFZ motivated not only by the IRC exemptions but also by the lowest general VAT rate in the EU (13 per cent).<sup>28</sup> They are aware that their activities are mobile by nature but that the jurisdictions from where they migrate may try to challenge their departure to the MFZ, namely because such jurisdictions will sense losses in revenue, especially VAT collected from private individuals outside a business activity, which is due at the rate of the place where the service provider is settled. Effective management in Madeira and need of personnel and infrastructure there are more prone to be accepted by 'new economy' investors than, for instance, by the traditional users of MFZ holding companies.

As anticipated, the new state aid regime, as outlined in the press release, is similar to the one of the *Zona Especial Canária* (ZEC)(Canary Islands Special Zone) on its stress in balancing tax incentives and direct employment.<sup>29</sup> Law no. 32-B/2002, of 30 December (Budget Law for 2003), foresaw a Parliamentary authorization for the Government to issue a decree that would transpose into Portuguese internal law the new Commission approved state aid. Seven months later (!) decree law no. 163/2003, of 24 July 2003, was published, replacing the previous 'born-dead' Art. 34 of the EBF. The new provision was slightly amended

by Law no. 107-B/2004 (Budget Law for 2004) so as to correct a few minor inconsistencies between the regime approved by the Commission and the decree law no. 163/2003-approved version.

Under a veil of ignorance, the question of the job creation is preoccupying the MIBC business community, as some doubts have already arisen. What is a 'job' in this context? The concept is not defined in the MFZ regime, as it also is not defined in the ZEC one ... Will part-time employment or remunerated company directorship, which are liable to social security and to personal income tax as dependent work, be considered for such purposes? We believe they should but the decree law is silent on this issue. Will the demands to proportionate jobs to the low-tax rate taxable income apply to pure holding companies (*Sociedades Gestoras de Participações Sociais* (SGPS)) benefiting from reduced IRC rates under the post-2003 MFZ regime, while there is absence of such requirements in the general law under which such companies may even qualify for full capital gain exclusion and dividend deduction (see 4.1. below)? We believe they should not. In the decree law the systematic reference to the SGPS *vis-à-vis* other types of companies is made *after* the job creation demands that apply directly to the latter, and there is no specific remittance to those demands for the SGPS. Therefore, it seems, under strict law and systematic principles of interpretation, that SGPS are waived from such demands.

As for the issue of the shelf-licenses, the term to incorporate a company only applies, as the press release indicates, for 'new licenses', those to be granted from 2003 onwards, and not to old licenses, those already granted in 2000 and before.<sup>30</sup> At the most,

<sup>27</sup> Francisco Costa, 'Notas sobre as perspectivas do' CINM, AAVV (org. SDM), *Dossier Técnico da Conferência, As Praças Internacionais de Negócios no Contexto da Economia Global - O Caso do Centro Internacional de Negócios da Madeira (Technical Dossier of the Conference The International Business Centres in the Context of the Global Economy - The Case of the Madeira International Business Centre)*, held in Funchal on 30 and 31 January 2003, pp. 313-323 (at p. 321), text distributed at the Conference, *O Centro Internacional de Negócios da Madeira - Presente e Futuro* (The Madeira International Business Centre - Present and Future), held in Lisbon on 23 June 2003 (at p. 9).

<sup>28</sup> See 4.2 below.

<sup>29</sup> See Ricardo Borges *et al.*, 'Portugal courts global business', *International Tax Review*, December 2000 to January 2001, vol. 12, no. 1, p. 60. See also 'Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation' at [http://europa.eu.int/comm/competition/state\\_aid/legislation/business/rapportaidesfiscales\\_en.pdf](http://europa.eu.int/comm/competition/state_aid/legislation/business/rapportaidesfiscales_en.pdf).

<sup>30</sup> Heleen Nijkamp, p. 149 defends that: '... companies that entered into the Madeira regime prior to 1 January 2000 are grandfathered under the state aid provisions of the EC treaty until 2011. Yet the Madeira regime is also considered harmful under the Code of Conduct and therefore the benefits should be terminated by 31 December 2005. Even more interesting is to see in what way the timeline for rollback will be applied to Madeira 1999 shelf companies that are used for the first time in 2001 or 2002. The question is, whether these companies will be able to benefit from the Madeira regime through 2002, 2005, or 2010. [footnote 27: Madeira 1999 shelf companies that are used for the first time in 2001 or 2002 may also be scrutinized as misuse of aid under Article 88, paragraph 2 EC Treaty]'

what Portugal could have done, under due process and law enforcement through time in transposing the new regime, was to force the incorporation of already licensed companies in a six-month or one-year term, counted from the date of entry into force of the new regime. But it did not. Portugal amended its administrative regulations on the MFZ licensing procedure (!) through the regional regulatory decree no. 6/2004/m, of 9 March. In our opinion, it did not go beyond what, under strict law, the Commission demanded it to.

Surprisingly, the Commission tries to exclude 'intra-group services' (coordination, accounting and distribution centres). We note that Portugal, unlike Belgium, for instance, does not have such 'centres'. Portuguese companies have wide legal capacity and may have ample social objects, being able to develop relationships with both group and non-group companies. There is no legally defined special purpose vehicle that could serve only the function of the mentioned 'centres' in the Portuguese legislation, besides, possibly, the *Agrupamento Complementar de Empresas* (ACE), the national equivalent to the European Economic Interest Grouping (EEIG). As far as our knowledge goes there is no single ACE - or, for that purposes, an EEIG - licensed to operate in the MFZ. The scope of the Commission *ditto*, after the initial shock, may therefore be more reduced.

Some business centres are regulated and promoted by two different authorities. The MFZ - like the ZEC - is not: the promoter and main regulator of the business centre is SDM, although other special supervision applies, namely in the financial sector (Bank of Portugal, Insurance Institute of Portugal, Securities Market Commission, etc.). It is reasonable to expect, under public choice analysis, that a promoter that is also a regulator will somewhat soften the practical enforcement of the regulations to boost new entrances in the MFZ and to derive more license income there from. Some administrative clarification - with the Commission consent and backed by the Portuguese Government and the Madeira Regional Government - on the most puzzling issues of the new regime, namely job creation, may therefore be expected in the, we hope, not distant future.

### 3. The Code of Conduct discussions

As mentioned in the first part of this article, these discussions are aimed specifically to end the measures considered harmful from a tax perspective. Following the issuing of the Code of Conduct on Business Taxation, the 23 November 1999 Primarolo Report listed 66 national measures considered harmful, elected from an assessment of more than 200. The list of the potential harmful tax measures includes four associated with tax incentives granted within the MFZ, identified as follows (Annex A - Description of Listed Measures):

- measure AAM114 - Holding Companies regime (SGPS);
- measure B006 - Madeira and Sta. Maria (Azores) Free Zones;
- measure C008 - Madeira Shipping Regime;

- measure DAM11 - Madeira Industrial Free Zones Portugal.

From these four measures only the one identified as B006 (MFZ) obtained a positive assessment, but restricted to the financial service activities permitted within the MFZ. In fact, in the conclusion (point 65 of the Report) regarding the positive assessment given to B006, it is stated that this relates only to the financial services permitted within the MFZ ('The Group acknowledged that the positive assessment given to B6 related only to the financial services activities permitted within Madeira ...').

The measure B006 was identified in the report under the topic '(i.) Financial Services, group financing and royalties payments'. From these, according with the already mentioned point 65, only the financial service activities obtained a positive assessment. The assessment was not made under the topic '(v.) Exempt companies and offshore companies'. Unlike measure B001 - The International Financial Services Centre (Dublin) - for instance, the assessment to measure B006 did not encompass simultaneously the group financing activities.

Financial Services Centre's activities can only be carried out by licensed entities, which are banks, other credit institutions and financial companies. Therefore, the assessment given by the Primarolo Group to the MFZ under the Code of Conduct discussions only covers the financial services activities allowed within the MFZ, which are rendered by the mentioned entities. All other areas of the MFZ were not assessed within this context, i.e. they were not included in the 66 measures elected as harmful from a tax perspective. These areas include the International Shipping Register, the Industrial Free Trade Zone and the International Services Centre, which comprises the holding and services companies. Thus, with the exception of the financial entities, the tax incentives granted in the MFZ were not considered as harmful.

As mentioned, in 27 November 2000, the Ecofin reached an agreement for a timeline on standstill and rollback regarding harmful regimes, as well as on

*cont.*

As will be explained in 3., 1999 and 2000-licensed MFZ companies have been confirmed as not subject to rollback. In our opinion, the use of such companies may also not be scrutinized as misuse of aid. First, shelf companies are a legally envisaged feature of the MFZ regime since 1987 (see 2.2.1. above) that was not driven by tax considerations in the first place. Secondly, the moment the license is issued should be understood as creating legitimate expectations and acting as a tacit agreement between the taxpayer and the state (see 2.2.2. above) and should not therefore be challenged. Thirdly, the Commission was clearly aware of the issue, but in the settlement of the MFZ procedures it only dealt with it towards the future. Given the global nature of the agreement reached between Portugal and the Commission, and the absence of specific challenge on this matter, it would be contrary to *bona fide* negotiations that the latter would raise its voice towards a situation to which it had been silent, re-opening the dispute. Additionally, the purpose of the agreement with the Commission was to safeguard the 1995 state aid decision as it was initially approved. Any challenge to the 1999 or 2000 licensed companies would be formally contrary to terms of that decision and would substantially breach the said purpose.



guidelines focusing on finance branches, holding companies and headquarter companies. Both the timeline and the guidelines are, in our opinion, to be applicable to the measures that were considered harmful by the Code of Conduct report. In this regard, any action to be undertaken under the conclusions of the Ecofin meeting of 27 November 2000, could only apply to the regimes that were considered harmful by the Code of Conduct, which, in the case of the MFZ, only includes the Financial Services Centre.

Under the Code, it is clear like water that the assessment made to the MFZ only includes the financial services activities, this meaning the services provided by banks and other financial institutions (points 32 and 65 of the Report). The holding structures and the intra-group financing were excluded from the assessment.

Additionally, the assessment made did not take into account Madeira's outermost condition or the proportionality of the measure under para. G of the Code of Conduct, and it is therefore theoretically possible that such consideration might drive measure B006 out of the scope of the blacklist.<sup>31</sup> The only existing reference to a challenge on '... certain international services (intra-group service firms and coordination centres)<sup>32</sup> is on the Commission invitation for comments.<sup>33</sup>

In conclusion, the International Services Centre was only referred under the Commission challenge on 'aid granted from 1 January 2000 onwards' for MFZ state aid purposes, and considered as non-compliant with the regional state aid guidelines of 1998, but not with the Code of Conduct of 1 December 1997, the Progress Report of the Code of Conduct Group of 20 November 2000, or the Ecofin conclusions of 27 November 2000.

We note that the expression used in the Progress Report of the Code of Conduct Group of 20 November 2000, for rollback is 'new entrants into exiting measures found harmful in the Group's Report to Ecofin of November 23, 1999'. The new guidelines did not, therefore, replace the definition of 'harmful', nor stretched the Primarolo list, but only provided a clarification in certain areas.<sup>34</sup>

Even if the rollback could apply to the MFZ international services companies, which it cannot, the idea of 'entrants into measures' conveys the idea that what is relevant is the moment where an entity entered into a certain regime. Under this reasoning, when an entity applies for a given regime, and is granted access to it, as is the case of the entities licensed (even if not yet incorporated) in Madeira, a certain para-contractual obligation was entered into between the Member State and the beneficiary.

Finally, the guidelines refer, as mentioned, to the Code of Conduct, and the latter ties harmful tax measures to state aid control in para. J. The enforcement of the provisions of the Code of Conduct relies on 'peer pressure' and political commitment and compliance by the EU Member States whereas state aid control is made by means of legally enforceable Commission and state decisions. The latter should therefore prevail over the former.<sup>35</sup>

With regard to this interaction we also point out that, with respect to timeline, the Presidency Ecofin note 13555/00, FISC 190, of 20 November 2000 (23.11), proposed that the Council:

'... (3) gives its approval, in cases where undertakings were deriving benefit from harmful arrangements on 31 December 2000, to such arrangements lapsing no later than 31 December 2005, whether or not they were granted for a fixed period;

(4) agree to undertakings being barred from entering into harmful arrangements after 31 December 2001 and deriving benefit from them after 31 December 2002.'

However, the Outcome of Proceedings of the Ecofin of 26-27 November 2000, 13898/00, FISC 207, of 28 November 2000 (12.12) approved its conclusions on the tax package (Annex 1), which, in its turn, approved the conclusions of the said Presidency note:

'... on the following conditions:

- addition to paragraph 3: "nevertheless, on a case-by-case basis, to take account of special circumstances, the Council may decide, on the basis of a report by the Code of Conduct Evaluation Group, to continue the effects of certain harmful arrangements after 31 December 2005<sup>36</sup>;
- paragraph 4 shall read: "agree to undertakings" being barred from entering into harmful arrangements after 31 December 2001, *except where such arrangements are the*

<sup>31</sup> See footnote 8 to the 23 November 1999, Primarolo Report. We note that para. G was introduced in the Code of Conduct due to Portuguese (and Spanish) pressure in the Council.

<sup>32</sup> The wording of this last expression is not very clear as, unlike the Belgium, and as already stressed in n. 4 and 2.3. above, we do not have that specific type of entities.

<sup>33</sup> See 'State aid - Invitation to submit comments pursuant to Article 88(2) of the EC Treaty concerning aid C 37/2000 (ex NN 60/2000, ex E 19/94, ex E 13/91 and N 204/86) - Financial and tax aid scheme for the free zone of Madeira (Portugal)', p. 6, and points 14 and 35 of the letter SG (2000) D/105023 of 17 July 2000, pp. 8 and 12, respectively. The Commission itself, on the said point 35, acknowledges that only the financial services were assessed as harmful by the Code of Conduct, and not the international services. See also the reference to the latter made by Monti on the Commission answer of 5 March 2001, to the parliamentary written question P-0277/01 by Sérgio Marques (PPE-DE) of 30 January 2001 (Madeira Free Zone. OJ, C 235 E, of 21 August 2001, pp. 168-169). No similar references are made by Bolkestein on the Commission answer of 16 June 2000, to the parliamentary written question P-1373/00 by Sérgio Marques (PPE-DE) of 26 April 2000 (Madeira Free Zone. OJ, C 46 E, of 13 December 2001, pp. 180-181) or by Monti on the Commission answer of 14 May 2002, to the parliamentary written question P-0975/02 by Sérgio Marques (PPE-DE) of 3 April 2002 (The Madeira International Business Centre (MIBC). OJ, C 309 E, of 12 December 2002, pp. 67-8).

<sup>34</sup> Against, Heleen Nijkamp, p. 148 and pp. 153-4.

<sup>35</sup> On these issues, similarly, see António Carlos dos Santos, the second text at n. 3 above, p. 14 and the second text at n. 1 above, pp. 419-420. Also, Diogo Ortigão Ramos, the text at n. 1 above, and Freitas Pereira, the text at n. 1 above, p. 216/p. 142.

<sup>36</sup> It is to be noted that this is not an altogether new possibility. In the 'Statements for the Council minutes 1. re Annex 1 (code of conduct)' of the 'Conclusions of the Ecofin Council Meeting on 1 December 1997 concerning taxation policy', OJ, C 2, of 6 January 1998, p. 2, the following remark was made: 'As from 1 January 1998 the actual rollback will have to take place within five years although a longer period may be justified in particular circumstances following an assessment by the Council'.

*subject of an existing Commission decision providing for longer duration within the framework of State aids, and, in any case, from deriving benefit from them after 31 December 2002.'*

Even the Commission in its Statements for the Council minutes (Annex 2 (as amended by Corrigendum to Outcome of Proceedings, 13898/00, FISC 207, of 6 February 2001)) acknowledged:

'1. With regard to the "special circumstances" referred to in the addition to paragraph 3 of the Presidency's note (13555/00 FISC 190), the Commission considers that where the period of a ban on a State aid laid down by an existing Commission decision continues after 31 December 2005 it must be possible to continue to apply that arrangement for that period.'<sup>37</sup>

It all pointed that incentives existing at 31 December 2000, should continue to apply beyond 2005 where the latter had been subject to a state aid approval, which was and is the case of the MFZ.

Subsequently, it was decided in the Outcome of Proceedings of the Ecofin meeting of 21 January 2003, 5566/03, FISC 8, of 22 January 2003, that:

'The Council agrees that, at the final adoption of the tax package and in the context of an agreement on the assessment of the results reached on the rollback of the harmful measures, extensions beyond the end of 2005 of benefits of the following measures are granted: ... - Portugal: Madeira's Free Economic Zone, extension to 31 December 2011' (point 10 of the agreed Council Conclusions on the Tax Package that are set out in the Annex to the document).

On 5 March 2003, the Code of Conduct Group presented yet another report to the Ecofin of 7 March 2003, 7018/03, FISC 31. Annex B summarizes the results of the Group's work on the evaluation of rollback of each of the measures listed in Annex C of the 23 November 1999, Primarolo Report - and is identical to part (a) of Annex 1 of the Group's report to the Ecofin meeting of 3 December 2002 (14812/02, FISC 299). With regard to MFZ (B006), the chart in that Annex states that 'Measure has been abolished' and denotes with an 'X' that the proposed revised or replacement measures were found not to have features which the Group considered to be harmful (see point 13 of the Report).<sup>38</sup>

Finally, the Ecofin meeting of 3 June 2003,<sup>39</sup> approved the 'Tax Package', including the Code of Conduct, the Council stating that it:

'Welcomes the progress achieved by the Code of Conduct Group (Business Taxation) as set out in its report (7018/1/03 FISC 31 REV 1 (en)).

Notes that the descriptions in Annex 1 of 14812/02 FISC 299, as updated by the descriptions in Annex A of 7018/1/03 FISC 31 REV 1 (en), form an agreed basis for the evaluation of rollback.

Notes that the Code Group has considered the proposed revised or replacement measures of Member States and of dependent or associated territories for those listed in Annex C of SN 4901/99 against the established criteria of the Code of Conduct and, as set out in Annex B

of 7018/1/03 FISC 31 REV 1 (en), has found that none of these are harmful within the meaning of the Code.

Agrees that the proposed revised or replacement measures are adequate to achieve rollback of all the harmful features of the 66 measures listed in Annex C of SN 4901/99.

Agrees to an extension of benefits beyond the end of 2005 as set out in paragraphs 15 and 17 of the Code of Conduct Group's report (7018/1/03 FISC 31 REV 1 (en)) and in paragraph 10 of the Annex to 5566/03 FISC 8.'

The approval of the Code of Conduct raises some doubts, namely what does this approval mean taking into account the numerous reservations and dissents expressed throughout the process. Nevertheless, it is evident that 'hard law' state aid took precedence over 'soft law' Code of Conduct - as it should - and in the end the Commission MFZ state aid decision of 1995 has been 'reinstated' in power, in the sense that entities licensed up to 31 December 2000, are not liable to rollback and are entitled to the IRC exemption regime up to 31 December 2011, as initially approved.

#### 4. Opportunities, trends and challenges

##### 4.1. Pure holding companies

Law no. 32-B/2002, of 30 December (Portuguese Budget Law for 2003) further enhanced the elimination of economic double taxation of distributed profits and capital gains for IRC purposes.<sup>40</sup> Under this new regime, pure holding companies (*Sociedades Gestoras de Participações Sociais*), as well as seed and risk capital companies (*Sociedades de Capital de Risco*), qualify, under certain conditions, for full capital gain exclusion and dividend participation deduction.

MFZ companies are Portuguese companies liable in

<sup>37</sup> Heleen Nijkamp, p. 149: 'The European Commission suggests in its statement that tax measures that have been approved under state aid for a period beyond 2005 should also be eligible for continuation beyond 2005 under the Code of Conduct. The Commission's statement makes clear that state aid decisions do not take precedence over the assessment by the Primarolo Group. Hence, a tax measure that has been approved under the state aid provisions of the EC Treaty for a period beyond 2005, yet is considered harmful by the Primarolo-Group, does not automatically qualify for continuation beyond 2005 under the Code of Conduct'. The author did not take into account the Corrigendum mentioned above. Before, the text read '... it ought to be possible to continue to apply for that period' - see footnote 21, p. 149. The new wording weakens the idea of independence between state aid and Primarolo Group assessment.

<sup>38</sup> See n. 1 above, for the similarity of the OECD approach.

<sup>39</sup> See '2513rd Council meeting- Economic and Financial Affairs - Luxembourg, 3 June 2003', PRES/03/149, Luxembourg, 3 June 2003, 9844/03, at <http://ue.eu.int/pressData/en/ecofin/76014.pdf>, 'Results of Council of Economics and Finance Ministers, Luxembourg, 3rd June 2003 taxation and financial services', MEMO/03/123, Brussels, 4 June 2003, and 'Taxation: Commission welcomes adoption of package to curb harmful tax competition', IP/03/787, Brussels, 3 June 2003, both at [http://europa.eu.int/comm/taxation\\_customs/publications/official\\_doc/press\\_releases\\_2003\\_en.htm](http://europa.eu.int/comm/taxation_customs/publications/official_doc/press_releases_2003_en.htm).

<sup>40</sup> See 'Legislation Portugal', *EC Tax Review* 2003, vol. 12, no. 2, pp. 120-121.

principle to the general IRC regime, in spite of the particular tax incentives applicable thereto. Therefore, each time the general IRC regime changes there are opportunities of two types:

- (i) sometimes the MFZ companies can benefit from the features of both the general and particular regimes;
- (ii) other times, limitations or negative tax consequences under the general regime are not applicable as such to the MFZ, given the special status of the latter.

The popular saying 'Madeira is the only tax haven that is not a tax haven' has never been truer and is given a new meaning by this Budget Law for 2003. On the one hand, and notwithstanding the general restrictions, MFZ SGPS will generally be exempt (pre-2001 licensed companies) or only taxed at the rate of 1 per cent (2003-licensed companies) on their dividend and capital gain income derived from shareholdings in non-EU territories, including even those deemed to be tax havens and blacklisted as such by the Ministry of Finance<sup>41</sup> due to its own exemption/reduced rate regime. On the other hand, and even though, as far as capital gains and dividends on EU shareholdings are concerned, MFZ SGPS do not benefit from an IRC exemption/rate reduction, they can nevertheless exclude such income from tax under the general regimes, provided that certain conditions are met.

One would think that the MFZ and the pure holding company would have been perfect companions since their respective inception. Surprisingly, however, the SGPS has never been a very popular vehicle in the MFZ. Several reasons help explain this. The SGPS has a limited social object, the management of qualified holdings, and is liable to special supervision by both the public General Inspection of Finance and by statutory auditors, something that renders its functioning more costly and less confidential. This drives away some investors, namely foreign, privacy-conscious, private individuals.

Another factor is that SDM demands, besides a fixed annual on-going license fee of €1,500, a variable license fee of 0.5 per cent of the SGPS taxable income of the previous year exceeding €1,000,000, up to a maximum of €30,000.<sup>42</sup> In our opinion, this SDM fee is contrary to the Portuguese Constitution, as the taxable income of MFZ companies has no relation whatsoever with the level of service provided by SDM. Therefore, the fee behaves as a disguised progressive tax, although with a cap. The authors, as well as other people, have been trying to convey this idea to SDM, and have proposed amendments to the regime, so that that SGPS companies become liable to a plain licensee fee.

Most of the factors that have rendered the SGPS less attractive *vis-à-vis* the so-called mixed holding company (an international services company that holds participations) have recently been dealt with. To eliminate doubts that had arisen since 1995, Budget Law for 2002 (Law no. 109-B/2001, of 27 December) interpretatively - in other words, retroactively but favourably - provided that income from participation,

namely dividends and capital gains, obtained by SGPS settled in the MFZ from holdings in companies not resident in the remaining Portuguese territory (aside from the MFZ itself) or in other EU Member States is exempt. The dominant, although challenged - namely by the authors of this article - view, was that only non-EU dividend income was 'income from participation holdings', and thus exempt from tax, while non-EU capital gain was not included the scope of that expression. The said Budget Law clarified that both are exempt. Apparently, it also stems from the said Budget Law that interest and service income derived from the participation holdings was also to be considered exempt income. Some confirmation that this is so is expected from SDM or from the Portuguese tax authorities. This makes pre-2001 licensed SGPS more neutral towards mixed holdings with regard to non-EU income. Additionally, the regime for 2003-2004 licensed companies will clearly tax all non-EU SGPS or mixed holding income at the 1 per cent rate, taking this neutrality one-step further.

Those issues that still represent a disparity (the special supervision and limited social object) between the two types of companies are not likely to be altered. The remaining differences in taxation of pure and mixed holding companies - concepts that have always tantalized investors and defied the reasoning and communication skills of the tax consultants - have been greatly reduced. If the approach towards an SGPS license fee change by SDM is successful, one can expect a surge of pure holdings in the MFZ.

#### 4.2. 'New economy' companies

Decree law no. 130/2003, of 28 June, transposed into Portuguese internal law the rules of the 'electronically supplied services' VAT Directive.<sup>43</sup> This Directive, in theory, forces non-EU companies supplying services by electronic means to non-VAT taxpayers resident in the EU to register herein, possibly in a single Member State. However, they will nevertheless have to assess VAT at each of the rates of the respective countries of their customers. In practice, non-EU companies will

<sup>41</sup> *Ibid.*, p. 119, for the complete list.

<sup>42</sup> This system immediately recalls the notary and registry fees litigation endured in the ECJ that has stricken down the former Portuguese regime, beginning with the *Modelo* case, of 29 September 1999 (Case C-56/98), *Recueil*, 1999, I, pp. 6427-6465.

<sup>43</sup> Council Directive 2002/38/EC, of 7 May 2002, amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, OJ, L 128, 15 May 2002, pp. 41-44. On this issue see, from Clotilde Celorico Palma: 'O IVA e as operações efectuadas via electrónica - alterações do Decreto - Lei no. 130/2003', *Revista TOC*, August 2003, no. 41, pp. 20-23; and previously, 'A proposta de directiva IVA aplicável a serviços prestados via electrónica', *Revista TOC*, November 2000, no. 8, pp. 32-38; as well as 'Comércio electrónico - algumas questões fiscais', *Revista TOC*, March 2000, no. 1, pp. 44-53, 'O IVA e o comércio electrónico - vantagens de localização dos operadores na Madeira', *Revista TOC*, October 2003, no. 43, pp. 20-23, also forthcoming in *VAT Monitor*.

most likely incorporate a subsidiary in the EU to render such services, in order to charge only one VAT rate to all their EU customers.

Madeira comes as their natural choice, not only because of the favourable IRC regimes, but also due to other incentives (namely property ownership and transfer tax exemptions) and specially its reduced VAT rates (4 per cent, 8 per cent and 13 per cent), the lowest in the EU.<sup>44</sup> These rates are rooted, with general character and without restrictions, in the Portuguese Accession Treaty to the European Economic Community (Addenda 4 Annex II, V, 2) and in the Sixth VAT Directive (Art. 12, no. 6). The MFZ has thus been marketed successfully among some Internet service providers and e-commerce enterprises, as well as telecommunication companies, given that in all these activities the 13 per cent VAT rate is applicable to supplies of services and sales of goods to non-VAT taxpayers resident in the EU.

Recently, the Commission has proposed a new vision for VAT in the EU.<sup>45</sup> In this framework, the Commission had already previously proposed changes to the scope of the reduced rates of VAT and among it to the Madeira feature, transforming the current 30 per cent reduction towards the Portuguese mainland national (19 per cent) VAT rate, which has an indefinite nature, into a temporary measure to be applicable during the transitional VAT period, and adding that:

‘... the lower rates thus applied must be strictly limited to goods and services giving rise to consumption in those territories. Recent experience has shown that the current derogations can give rise to abuse: for example, there have been cases of businesses in the e-commerce and telecommunications sectors moving to the Azores and Madeira in order to apply the lower rates applicable there to services they supply to final consumers throughout the Community. Steps must be taken to put a swift end to such practices as they are a misuse of the derogations which were granted solely to allow the Member States concerned to take account of the remoteness and special geographical situation of those regions.’<sup>46</sup>

The Portuguese Commissioner has dissented to this proposal, and the Portuguese Government, to our knowledge, is rejecting this qualification of abuse and is going to oppose the Commission proposals.

#### 4.3. Financing structures

The Portuguese regime on the issuing of bonds has, like that of most countries, some constraints. However, specific waivers can be obtained for individual situations under Art. 348, para. 3, of the Portuguese Commercial Companies Code. More interesting, however, is the possibility of a general waiver set in Art. 349, para. 3, of the said Code. In our opinion, this provision allows for a Ministerial Order of the Ministries of Finance and Justice, of a general and abstract nature, which might enable MFZ companies at large, under certain conditions, to issue (international) bonds. This would enhance, without any tax expenditure or amendments, the public financing of MIBC

companies. This is especially important under the 2003-2006 regime, where accounting - the Portuguese EBF translation was ‘tesouraria’ (treasury), apparently aiming at intra-group financing - centres are denied the new tax incentives. The authors have raised this idea to SDM, and hope that it will be promoted efficiently with the Portuguese Government so that it may turn into a real opportunity.

## 5. Conclusions

In view of the above, we set out below the main conclusions of our analysis.

Taking into consideration the state aid regime and the assessments made under the Primarolo Group, in what concerns MFZ entities, the Commission only substantially challenged, in theory, the tax incentives granted to financial institutions. The challenge resulted from the positive assessment given to the financial services activities allowed within the MFZ by the Code of Conduct Group report issued in 23 November 1999, and translated into the non-renewal of new entrances in that sector under the new 2003-2006 state aid regime. However, in practice, the ‘aid granted from January 1, 2000 onwards’ investigation procedure spanned from its initial object and affected all the areas of the MFZ.

Entities licensed until the end of the year 1999 may benefit from an IRC exemption regime until the end of 2011. Entities licensed during 2000, pursuant to the state aid decision taken by the Commission back in 1995, should also benefit from the IRC exemption regime until the end of 2011. However, the fact that, in 1998, the Commission requested changes as from

<sup>44</sup> See European Commission, Directorate-General, Taxation And Customs Union, Tax Policy, VAT and other turnover taxes, *VAT Rates Applied in the Member and Accession States of the European Community - Situation at 30 October 2003*, DOC/2402/2003 - EN, pp. 20 and 30, at [http://europa.eu.int/comm/taxation\\_customs/publications/info\\_doc/taxation/tva/taux\\_tva-2003-10-1\\_en.pdf](http://europa.eu.int/comm/taxation_customs/publications/info_doc/taxation/tva/taux_tva-2003-10-1_en.pdf) and [http://www.neubrandenburg.ihk.de/steuerinfos/bilderunddocs/taux\\_tva-2003-10-1\\_en.pdf](http://www.neubrandenburg.ihk.de/steuerinfos/bilderunddocs/taux_tva-2003-10-1_en.pdf).

<sup>45</sup> See ‘Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - Review and update of VAT strategy priorities’, Brussels, 20 October 2003, COM(03) 614final, at [http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003\\_0614en01.pdf](http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0614en01.pdf). An important feature will be the change of rules on the place of supply of services; see European Commission, Directorate-General, Taxation And Customs Union, Tax Policy, VAT and other turnover taxes, *Summary Report on the outcome of the TAXUD Consultation [May - June 2003], VAT - The Place of Supply of Services*, TAXUD/ C3 /2357, 12.9.2003, at [http://europa.eu.int/comm/taxation\\_customs/taxation/consultations/vat\\_supply\\_results\\_en.pdf](http://europa.eu.int/comm/taxation_customs/taxation/consultations/vat_supply_results_en.pdf); ‘Proposal for a Council Directive amending Directive 77/388/EEC as regards the place of supply of services’, Brussels, 23 December 2003, COM(2003) 822final - 2003/0329 (CNS), at [http://europa.eu.int/eur-lex/en/com/pdf/2003/com2003\\_0822en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2003/com2003_0822en01.pdf).

<sup>46</sup> See points 74 and 79, pp. 17, 18 and 19, respectively, of the ‘Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax’, Brussels, 23 July 2003, COM(2003) 0397final - CNS 2003/0169, at [http://europa.eu.int/eur-lex/en/com/pdf/2003/com2003\\_0397en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2003/com2003_0397en01.pdf). See also Note of the Presidency to the COREPER/ ECOFIN Council on ‘VAT: reduced rates. Orientation debate’, Brussels, 29 September 2003, 12990/03, FISC 132.

January 2000 onwards, instead of January 2001 (the initial term of the 1995 state aid decision), made the matter uncertain for some time. However, all authorities – Commission included – now acknowledge that the previous IRC exemption regime also encompasses entities licensed in 2000.

Regarding the new 2003–2006 Commission state aid approved MFZ regime, it is less attractive than the former, but more attractive than many other similar regimes. Given the volume of companies licensed in 1999 and 2000 in view of the expected changes in taxation and regulation, the market for MFZ will, for some time, be served from that lot rather than from the 2003 onwards one. 2000-licensed companies, like 1999-licensed companies before them, will therefore become land in a Ricardian sense.<sup>47</sup>

One can say that all is well when it ends well. Even the years 2000, 2001 and 2002 have not been the *annus horribilis* for the MFZ that one might imagine at first, in spite of the license freezing and the misinformation, rumour, secrecy and inherent fears stemming from the EU procedures, in the context of a worldwide economic downturn. The MFZ business community (management and tax consulting compa-

nies) have been able to guide optimistic investors among the fog to explore new opportunities (pure holding and ‘new economy’ companies) even in such turbulent times.

In conclusion, we believe that 2003 marked the frontier between two ages for the MFZ, with the replacement of a loosely constrained exemption by a more stringent and reduced rate regime. The clock has started ticking again. 2003 saw the licensing of the first twenty-first century companies in Madeira. It was about time ...

<sup>47</sup> See Ricardo Borges *et al.*, p. 60: ‘David Ricardo, the 19th-century UK economist with Portuguese ancestors, argued that since the supply of land is inelastic, land will always work for whatever competition is willing to give it. Thus the value of the land as a fixed factor derives entirely from demand, and not from supply. The comedian Will Rogers also said, “Land is a good investment: they ain’t making it no more”. 1999-licensed Madeira companies are land in the Ricardian sense and quite a good investment: “they ain’t making it no more”. It is therefore understandable, given the uncertainty surrounding the MTFZ, that these 1999-licensed Madeira companies carry a premium towards plain 2000 companies’.

## Overview on the recent developments of the EC Directive on Withholding Taxes on Royalty and Interest Payments<sup>1</sup>



Klaus Eicker, *Ernst & Young, Munich*

Fabio Aramini, *Studio Legale Tributario in association with Ernst & Young, Rome*<sup>2</sup>

At first sight it seems that the EC Directive on Withholding Taxes on Royalty and Interest Payments which was designed adopting the technique of the Parent-Subsidiary Directive should not involve considerable issues when being applied to given cases. However, the first comments on the various proposals and the final adopted version indicate that this is not the case,<sup>3</sup> as do the recent proposals for two amendments (one proposal had been already adopted) as well as the hesitant implementation of the Directive in the 25 Member States and the consequent confusion. This article tries to shed some light onto the complex situation.

### 1. Economic and historic background of the Directive

As between associated companies, the following taxable business transactions are open to potential

double taxation, or the taxation itself may exert an obstacle: the transfer of assets, the distribution of dividends, the granting of loans and the granting of licenses. A single European market which is defined as a market without barriers for the free flow of goods, persons, services and capital and which should resemble a domestic market has to provide for circumstances by which cross-border transfer of assets and capital is not distorted by capital gains taxes or withholding taxes. Tax wise, the Merger Directive

<sup>1</sup> Directive of 3 June 2003 (2003/49/EC), OJ, L 157 of 26 June 2003 at 49.

<sup>2</sup> Both authors are Senior Managers and Members of the EU Competence Group of Ernst & Young.

<sup>3</sup> See Oliver, *Intertax* 1999, p. 204; Raventos, *European Taxation* 2000, p. 286; Cerioni, *European Taxation* 2004, p. 47; Distaso and Russo, *European Taxation* 2004, p. 143.