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MADEIRA AND GIBRALTAR HOLDING COMPANIES AND THEIR STATUS UNDER THE PARENT-SUBSIDIARY DIRECTIVE

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Introduction

On 23rd July 1990 the Council of the European Communities adopted the Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 90/435/EEC, hereinafter referred to as "the Parent-Subsidiary Directive" or simply as "the Directive".

The purpose of the Directive is to facilitate the grouping together of companies within the European Union (hereinafter: "the EU") by reducing the occurrence of international double-taxation on dividends flowing from a company in one Member State to its shareholder company in another. To ensure the necessary fiscal neutrality, the Directive prescribes the dividend exemption and the participation exemption or participation credit. These concepts are briefly described below in paragraph 2.

The Directive was implemented in the tax systems of the EU Member States as per 1st January 1992.

In connection with this implementation, Gibraltar and Madeira have introduced specific provisions aimed at passing on the benefits of the dividend exemption contained in the Directive to non-EU investors and entrepreneurs.

The idea behind the introduction of these provisions is that the direct participation of, for instance, a US or Japanese group in a subsidiary within the EU will give rise to withholding tax levied at a substantial rate once dividends are distributed. By structuring the investment under a Gibraltar or Madeira holding, such dividend

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withholding tax can be eliminated (i.e., the State of residence of the subsidiary may not levy withholding tax), provided the interposed holding qualifies under the Directive. The special Gibraltar and Madeira tax provisions ensure that EU dividends can be received and redistributed by holding companies at a low effective rate of Gibraltar and Madeira tax. In other words: the special holding provisions intend to enable non-EU persons to replace the substantial rate of dividend withholding tax levied by the State of residence of the EU subsidiary, by a considerably lower tax burden incurred in Gibraltar or Madeira.

This article discusses whether Gibraltar and Madeira have been successful in passing on the benefit of the Directive's dividend exemption and in stimulating the use of their jurisdictions for setting-up "Euroholding" companies. The pivotal issue is whether the Gibraltar and Madeira holdings qualify under the Directive, so that EU Member States are under the obligation to refrain from levying withholding tax on dividends paid by qualifying participations to their Gibraltar or Madeira parent.

This article starts by describing the Directive, followed by an outline of the relevant provisions of the Gibraltar and Madeira tax systems. Then whether or not the new Euroholdings comply with the Directive's requirements is reviewed. The anti-abuse measures that might affect the success of the new Gibraltar and Madeira Euroholdings are mentioned briefly. The article ends with a summary and a conclusion.

The Parent-Subsidiary Directive

(a) General

The Parent-Subsidiary Directive seeks to eliminate double-taxation of dividends flowing from a subsidiary company in one EU Member State to a parent company in another.

Firstly, it stipulates that the State of residence of a parent company which receives dividends from its subsidiaries either refrains from taxing such dividends, or taxes such dividends while authorising the parent company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary which relates to the profits from which the dividends were paid. This is the "participation exemption" or "participation credit".

Furthermore, the Parent-Subsidiary Directive provides for an exemption from withholding tax on dividends paid by a subsidiary to its parent company[2] — the so-called "dividend exemption".

This article concentrates on the position of Gibraltar and Madeira companies as EU holding companies owned by non-EU shareholders. As it is clear that the holding companies can receive and redistribute dividends without incurring substantial Gibraltar or Madeira taxes, the main issue is whether such holding companies qualify as parent companies under the Directive, so that they can claim the dividend exemption. The participation exemption/credit will not be discussed.[3]

(b) The Requirements

The dividend exemption is contained in Article 5 of the Directive.

It provides that tax authorities in the State of residence of a subsidiary **must refrain** from levying withholding tax if a subsidiary distributes profits to its parent company, where the latter holds a minimum of 25% of the capital of the subsidiary. Member States can choose to impose a minimum holding period of no more than two years and they can replace, by means of bilateral agreement, the criterion of a holding in the capital by that of a holding of voting rights (Article 3 of the Directive).

Only an entity that qualifies as a "company of a Member State", as defined in Article 2 of the Directive, can acquire the status of "parent company".

Pursuant to this provision an entity can only be a "company of a Member State" if it:

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2 Article 5(2), (3) and (4) of the Directive contain exceptions for Greece, Germany and Portugal.

3 Although the Parent-Subsidiary Directive provides the same set of criteria for the participation exemption and the dividend exemption, some Member States apply a subject to tax criterion (see below) in respect of the participation exemption that is more stringent than stipulated in the Directive. Some commentators argue that the Parent-Subsidiary Directive does not allow Member States to impose such additional subject to tax requirements. See Rouwers, RWG, Wijs RJB and Simonis PHM (1992) 'Implementatie van de moederdochter richtlijn', *Weekblad* 1992/8020, 20th August 1992 pp 1099-1115.

(i) is a resident in an EU Member State according to the tax laws of such Member State[4] (Article 2(b));

(ii) takes one of the legal forms listed in the Annex to the Directive (Article 2(a)); and

(iii) is subject to one of the taxes listed in Article 2(c) of the Directive, without the possibility of an option or of being exempt (Article 2(c)).

The Gibraltar 1992 Company and the Madeira SGPS

(a) The Gibraltar 1992 Company

The company created for holding purposes in Gibraltar is the Gibraltar 1992 Company. The Gibraltar 1992 Company rules do not create a special profit taxation regime. They rather provide for a withholding tax on outgoing dividends of just 1%, if some requirements are met. Furthermore, Gibraltar has implemented the Parent-Subsidiary Directive through its Parent and Subsidiary Company Rules. Pursuant to these rules, dividends received are exempt from corporation tax if the company holds, for a minimum of four months, an interest of at least 25% of the voting capital of an EU subsidiary.

It is important to note that capital gains on the disposition of shares seem to be fully subject to Gibraltar corporation tax at a rate of 35%, since they are not covered by the said Parent and Subsidiary Company Rules.

Summarising, a Gibraltar 1992 company that receives dividends from an EU participation that qualifies under the Parent and Subsidiary Company Rules and redistributes these dividends, incurs an aggregate Gibraltar tax rate on the gross amount received of 1%. Capital gains on the disposition of shareholdings are not exempt.

(b) The Madeira SGPS

The "Sociedad Gestoras de Participacoes Sociais" (the "SGPS") is the prescribed legal form for Portuguese companies with the exclusive object to manage participations in other companies (so-called "pure holding companies"). SGPSs are expressly regulated by Portuguese commercial

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4 The Directive adds "and, under the terms of a double taxation agreement concluded with a third State, is not considered to be resident for tax purposes outside the Community".

law. For instance, commercial law prohibits any direct business activities by SGPSs.

Since 1988, specific entities located in the Madeira Free Zone may be fully exempted from corporation tax until 31st December 2011. Also for Madeira SGPSs, such full tax exemption was available until 1st January 1993.

As from 1st January 1993, a special tax regime for Madeira SGPSs applies; this regime is geared at having the SGPSs qualify for the benefits of the Parent-Subsidiary Directive.

Pursuant to Article 41(1)(g) of the Tax Incentive Statute, the SGPS is exempt from corporation tax for income derived from shareholdings in companies which are not resident in the territory of Portugal or in another EU Member State.

The SGPS is subject to tax on EU (including Portuguese) source dividends. However, Portuguese source dividends are exempt for 95% of the gross amount under the Portuguese participation exemption. Similarly, EU source dividends are exempted for 95% of the gross amounts, provided the SGPS owns a minimum of 25% of the share capital of the distributing subsidiary for at least two years before the dividend is paid. In case the participation exemption applies to all EU source dividends, such dividends are taxed against an effective tax rate of 1.80% (i.e., 5% of 36%).

As Article 41(1)(g) of the Tax Incentive Statute and the Portuguese participation exemption apply only to "income", capital gains on the disposition of shareholdings will be taxable against the ordinary 36% rate of Portuguese corporation tax, unless the entire consideration received is reinvested in other shares or qualifying bonds.[5]

Finally, Article 41(2) of the Tax Incentive Statute provides that no tax is to be withheld from distributions of profit by the Madeira SGPS, provided the profit did not originate in Portugal.

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[5] See, Dr Francisco de Sousa da Câmara, 'Madeira Free Zone Legislation Amended', *European Taxation*, Volume 34, 1994, No 1-2.

The Gibraltar 1992 Company and the Madeira SGPS as "Companies of a Member State"

EU Member States must refrain from withholding tax on dividends paid on a qualifying 25% participation only if these dividends are paid to an entity that is a "company of a Member State", as defined in the Parent-Subsidiary Directive.

Below, the status of the Gibraltar 1992 Company and the Madeira SGPS is tested under the three prong definition of Article 2 of the Directive, set out in paragraph 2(b) above.

(a) EU Member State

The Gibraltar 1992 Company and the Madeira SGPS must be residents in an EU Member State according to the tax laws of such Member State.

According to Portuguese (Madeira) tax law, a Madeira SGPS has its tax residence in Portugal (Madeira), just as a Gibraltar 1992 Company, pursuant to Gibraltar tax law, is considered to reside in Gibraltar.

The issue is whether or not Madeira and Gibraltar form a part of a Member State of the EU.

Madeira

From a public international law point of view, the province of Madeira forms an integral part of the territory of Portugal. Moreover, Madeira was included in Portugal's accession to the EEC. Accordingly, Madeira should be considered as a part of the Member State Portugal for purposes of the Parent-Subsidiary Directive.

Gibraltar

The status of Gibraltar is less clear.

Gibraltar is a British Dependent Territory and as such is not part of the territory of the United Kingdom, which comprises England and Wales, Scotland and Northern Ireland.

In December 1991 the UK Inland Revenue published a so-called "Consultative Document" which explicitly states that the Parent-Subsidiary Directive applies also to Gibraltar by virtue of Article 227(4) of the Treaty establishing the European Economic Community.

Article 227(4) of the EEC Treaty provides that:

> "The provisions of this Treaty shall apply to the European territories for whose external relations a Member State is responsible."

The Government of the UK is responsible for Gibraltar's external relations and Gibraltar was included in the United Kingdom's accession to the EEC on 1st January 1973. So Gibraltar is European territory to which EU law, in principle, applies.[6]

The fact that Gibraltar is part of the European territory to which EU law may apply, nevertheless, does not automatically entail Member State-status for Gibraltar. A literal reading of Article 227(4) of the EEC Treaty indicates that EU law may apply to Gibraltar not because it is to be viewed as a (part of a) Member State but rather in spite of the fact that it is not a (part of a) Member State.

However, in light of the fact that the territorial scope of EU legislation very often is determined by reference to the term "Member State" (Gibraltar is seldom mentioned in Acts of EU institutions), considered in conjunction with the purpose of Article 227(4) of the EEC Treaty to bring the EU dependent territories within that scope, it might be argued that the term "Member State" should be interpreted expansively.

In this respect it is of importance that several EU States have confirmed that Gibraltar is considered a Member State, at least for purposes of the 1969 **EU Directive on the contribution of capital**.[7] [8]

The Danish tax authorities have confirmed that they agree with the statement of the UK Inland Revenue that the Parent-Subsidiary Directive applies to the territory of Gibraltar.[9] Also the Netherlands Ministry of

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6 Compare, Mr Jacques Delors, answering question number 635/87 of 26th June 1987 of Mr James Ford, Member of the European Parliament; Pb number 295/32 of 5th November 1987 (Annex 3).

7 Directive 69/335/EEC of 17th July 1969.

8 An argument commonly used for considering references to the term "Member State" in the Directive of 17th July 1969 to also encompass Gibraltar, is that the explicit exclusion of four specific policy areas in Article 28 of the UK's Accession Treaty of 1973 contains an implicit confirmation that EU Directives in non-excluded areas apply to Gibraltar.

9 See *Tax Planning International Review*, vol 19 nr 12, December 1992, p 20.

Finance seems to assume that the **territorial scope** of the Parent-Subsidiary Directive includes Gibraltar.[10]

(b) Legal Form

For the Madeira SGPS and the Gibraltar 1992 Company to qualify under the Parent-Subsidiary Directive, they have to take one of the legal forms listed in the Annex to the Directive.

The Madeira SGPS

With respect to Portugal, the Annex lists commercial companies or civil law companies having a commercial form, co-operatives and public undertakings incorporated in accordance with Portuguese law.

Pursuant to Portuguese tax law, the SGPS must be organised either as a corporation (SA) or a limited liability company (Lda). Consequently, the legal form of the SGPS meets the requirements of the Parent-Subsidiary Directive.

The Gibraltar 1992 Company

The legal form of the Gibraltar 1992 Company (or any other company incorporated under Gibraltar law) is not mentioned in the Annex to the Parent-Subsidiary Directive. Although Gibraltar company law is rooted in UK company law, it is part of a separate legal system. Therefore, the Gibraltar 1992 Company is not incorporated under the law of the United Kingdom.

Should (or can) it be argued that in the context of Article 227(4) of the EEC Treaty, letter (L) of the Annex of the Parent-Subsidiary Directive — referring to "companies incorporated under the law of the United Kingdom" — also includes companies incorporated under Gibraltar law?

The Danish Ministry of Finance announced in 1992 that it considers the Parent-Subsidiary Directive to apply to companies registered under the Gibraltar company ordinance.[11]

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10 See Announcement by the State Secretary of Finance of 28th July 1994, nr IFZ94/830, published in *Vakstudie Nieuws* 25th August 1994, pp 2674-2675.

11 See footnote 9 above.

However, it seems questionable that the context of Article 227(4) of the EEC Treaty can lead to such an expansive interpretation of the phrase "law of the United Kingdom".

Although Gibraltar's special relation with the UK might bring it within the territorial scope of the Directive, Article 227(4) of the EEC Treaty does not provide a general definition; it does not stipulate that the term "UK law", whenever used in EU law, encompasses "Gibraltar law".

But if Gibraltar is a part of the EU territory to which the Directive applies, does it then not follow logically that "its" companies should also be entitled to the benefits of the Directive? Not necessarily. In this respect it is important to see that the Annex does not list all the forms of enterprises that are organised under the laws of the Member States and that are subject to corporation tax therein.

It should also be noted that the UK Inland Revenue in their aforementioned Consultative Document do not state explicitly that Gibraltar companies have the required legal form (or are subject to a listed tax). It is stated merely that the Parent-Subsidiary Directive is to be applied to Gibraltar and that:

> " ... Gibraltar companies **satisfying the requirements of the Directive(s)** are entitled to the benefit (of the Directive)" [emphasis added], see paragraph 1.6 of the Consultative Document).

It is unclear whether the UK Inland Revenue refer only to the minimum 25% participation requirement and a possibly applicable minimum holding period or if they intend that the "requirements" that should be checked also comprise, for instance, the legal form of the company.

(c) Subject to Tax

A company can only be viewed as a "company of a Member State" if it is subject to one of the taxes listed in Article 2(c) of the Directive without the possibility of an option or of being exempt.

This requirement contains three sub-tests, namely:

- is the company subject to a tax contained in the said list?
- without being exempt? and
- without an option?

Commentators disagree on the actual nature of the requirement that companies should be subject to tax without being exempt.

It might be argued that since the Directive merely requires that the **company** is subject to tax, an exemption of (part or whole of) the taxable basis or object (a so-called "objective exemption") should not lead to disqualification of the company from the benefits of the Directive.

Some commentators, however, argue that the wording of the Directive indicates not only that the company should be subject to tax, but also that the items of income received by the company should be subject to tax to some degree.[12]

This leaves the question to what extent the taxable base may be eroded through an objective exemption, before the company is disqualified from Directive benefits. A full objective exemption is fatal in this view; a nearly complete objective exemption might very well be fatal.

The disqualification of companies that have a choice to be subject to tax or not was included because, until 31st December 1986, a Belgian "Société de personnes à responsibilité limitée" could opt to have its beneficiaries taxed on its profits instead of being taxed itself (i.e., an option for so-called "fiscal transparency"). From this it can be argued that the decisive issue is whether the company itself has an option of (non-)taxability and not whether the shareholders had the option to choose a non-taxable entity at the time they chose the business structure.

The Madeira SGPS

The Madeira SGPS is subject to the Portuguese tax listed in Article 2(b) of the Directive (the "imposto sobre o rendimento das pessoas colectivas") without an option of being subjectively exempted. However, it enjoys a substantial objective exemption comprising income from non-EU shareholdings and 95% of the income from EU shareholdings.

Whether or not the Madeira SGPS qualifies under the Directive may depend on the nature of the subject-to-tax provision employed in Article 2 of the Directive. Where there is uncertainty regarding the interpretation of the subject-to-tax requirement, the relevant national court has the obligation to submit the question to the European Court of Justice for an interpretative ruling. This means that the interpretation of the said

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12 See Van der Geld JAG. 'Het wetsvoorstel tot implementatie van de EG Moeder-Dochter richtlijn', *Weekblad* 1991/5985, pp 1633-1646.

requirement will ultimately be established by the European Court of Justice.

The objective exemption cannot lead to disqualification of the SGPS if the Directive employs a purely subjective criterion.

If the subject-to-tax requirement also entails a limit to the degree in which the taxable basis may be "eroded" by an objective exemption, then there is a chance that the Madeira SGPS does not qualify for the benefits of the Directive. The objective exemptions for the Madeira SGPS narrow down the "normal Portuguese" taxable basis substantially. But since the exemptions do not exclude from the taxable basis 5% of the EU source dividends received and any capital gains on disposition of EU or non-EU shareholdings, the effect of the objective exemptions differ considerably from a full subjective exemption of the SGPS.[13] Therefore, the chance that an SGPS is determined not to be subject to tax seems remote. Nevertheless, the Dutch Ministry of Finance has announced that it considers the Madeira SGPS not to comply with the Directive's subject-to-tax requirement.[14]

The tax authorities of Portugal are of the opinion that a Madeira SGPS is subject to tax as stipulated by the Directive.[15]

The Gibraltar 1992 Company

Gibraltar (corporate) income tax is not mentioned in the list of Article 2(b) of the Directive.[16]'

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13 To draw the maximum benefit from the Madeira SGPS regime, it might be necessary to have the "target" subsidiary issue a separate class of shares on which dividends will flow (class A shares) and another class of shares on which the capital gain accrues (class B shares). Class A shares can be held through the Madeira SGPS and class B shares through a Euroholding in a jurisdiction that exempts capital gains on qualifying EU shareholdings.

14 See the Announcement mentioned in footnote 10 above.

15 See *Tax Letter Europe* 15/92 3rd August 1993, pp 1-2.

16 Pursuant to Article 2(b) of the Directive, companies that are subject to a tax that is identical or fundamentally similar to a listed tax which is levied subsequently or in addition to or in place of that tax, have also met the subject-to-tax requirement. However, Gibraltar income tax is not a tax that can be viewed as supplementing ("in addition to") UK corporation tax and it has not "subsequently" replaced it.

Should, or can, it be argued that in the context of Article 227(4) of the EEC Treaty, the term "UK corporation tax" also includes Gibraltar income tax?

At least the Danish tax authorities seem to think so, where they state that the Directive normally should apply to companies that are resident and registered in Gibraltar.[17]

As argued above in paragraph 4(a) and 4(b), Article 227(4) of the EEC Treaty might lead to the conclusion that Gibraltar belongs to the EU territory to which the provisions of the Directive apply, but it does not provide a general definition. The term "UK corporation tax" does not encompass Gibraltar income tax.

Had the Gibraltar income tax been included in the list of Article 2(b), then the Gibraltar 1992 Company probably would have passed the subject-to-tax test. The exemption is limited to EU dividends, other items of income are not excluded from the taxable base.

Anti-Abuse Measures

Article 1(2) of the Parent-Subsidiary Directive provides that it shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.

The French, Italian and Spanish laws that implemented the Directive contain provisions that exclude applicability of the Directive for (EU) holding companies that are controlled by non-EU persons that have interposed such holdings to enjoy the benefits of the Directive.

In the light of the fact that Euroholdings set up in Madeira and Gibraltar are of specific interest to non-EU investors and entrepreneurs, the said anti-abuse measures have a direct impact on the chances of success for the Gibraltar 1992 Company and the Madeira SGPS.

Summary

- In connection with the implementation of the Parent-Subsidiary Directive throughout the EU in 1992, Gibraltar and Madeira have introduced specific domestic measures aimed at stimulating the use of their

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[17] See footnote 9 above.

jurisdictions for setting up Euroholding-companies (the so-called Gibraltar 1992 Company and the Madeira SGPS).

- The use of such Euroholdings would enable non-EU persons with EU-subsidiaries to replace a substantial level of dividend withholding tax levied in the State of residence of the subsidiary by a low effective Gibraltar or Madeira tax rate.

- The EU State of residence of the subsidiary is under the obligation to refrain from levying dividend withholding tax, only if such a Euroholding qualifies as a "parent company" for purposes of the Directive.

- A "parent company" must be a "company of a Member State". The Directive contains a three-prong definition of the latter term. All three conditions must be fulfilled for a company to qualify for the benefits of the Directive.

- Firstly, the company must be a resident in a EU Member State.

  - The Madeira SGPS resides in Madeira and the Gibraltar 1992 Company is a resident of Gibraltar. Madeira is a province of the Member State Portugal and it can be argued that also Gibraltar is part of the EU territory to which the Directive applies by virtue of its special relationship with the UK.

- Secondly, the company should take one of the legal forms prescribed by the Directive.

  - The legal form of the Madeira SGPS is listed, the legal form of the Gibraltar 1992 Company is not.

- Thirdly, the company should be subject to one of the taxes listed in the Directive. The nature of this subject-to-tax requirement is not clear. Ultimately, the European Court of Justice must provide clarity on this point.

  - Anyone contemplating the use of a Euroholding should be aware of the risk that the Madeira SGPS is not subject to tax, within the meaning of the Directive. This risk, however, does not seem substantial.

  - The Gibraltar 1992 Company is subject to Gibraltar income tax. However, this tax is not listed in the Directive. Consequently, the Gibraltar 1992 Company is not subject to tax for the purposes of the Directive.

- If EU-investments are structured under a Euroholding, due regard should be paid to the relevant (domestic and treaty) anti-abuse provisions.

Conclusion

The Gibraltar 1992 Company might serve as a holding company for shareholdings in EU Member States that have acknowledged the status of this company under the Parent-Subsidiary Directive. Presently, only Denmark has done so. The Madeira SGPS might find a broader application, depending on how one assesses the risk that the SGPS is not subject to Portuguese corporation tax for Directive purposes. Considering that the taxable base of the Madeira SGPS includes 5% of EU source income and all capital gains on the disposition of shareholdings, one may conclude that the risk of the relevant tax authorities successfully taking the position that the SGPS is not subject to tax, is minor. In structuring EU shareholdings under a Gibraltar 1992 Company or a Madeira SGPS, the tax benefit can be optimised by limiting the potential for capital gains on the shares held by these Euroholdings.