ANALYSIS OF ARTICLE 2(C) OF THE PARENT-SUBSIDIARY DIRECTIVE

Madeira Holding Companies and their Status under the Parent-Subsidiary Directive: Another View[1]

Francisco de Sousa da Câmara[2]

In the second issue of the *EC Tax Journal* Bart Rubbens discusses the applicability of the parent-subsidiary directive (hereinafter called "PSD") to Madeira and Gibraltar holding companies drawing a parallel as if they were twin brothers.[3]/[4]

---

1 I must stress that the terms "Madeira holding company", "Madeira SGPS" or "Madeira Company" do not exist legally. They are nothing but commercial and common designations to define a company incorporated or licensed to operate in Madeira Free Zone. Taking this perspective I will also use those terms to simplify the reading and understanding of these comments. The terms "Madeira holding company" or "holding companies" refer to pure holding companies (SGPSs) and will not include mixed holding companies which have a different tax régime.

2 Francisco de Sousa da Câmara, Master in Tax Law, Partner at Morais Leitâo, J Galvâo Teles & Associados, Law Firm, Rua Castilho 75 - 1°- 1250 Lisboa, Portugal. Tel:(+351 1) 386 31 74 Fax: (+351 1) 386 10 19.

3 Basically, this comparison was justified by the announcement of the Dutch State Secretary of Finance of 28th July 1994, n○IFZ 94/830.

4 Traditionally Gibraltar is compared with other tax jurisdictions which owe allegiance to the British Crown such as the Isle of Man and the Channel Islands (See A D Ross, Isle of Man, Channel Islands, Gibraltar: Taxation Systems Compared and Contrasted", *European Taxation* 1987: 303-311). Nowadays, generally, authors argue that Gibraltar Companies do not fulfil the PSD requirements not only because they are exempt from taxes but mainly pointing out that those Companies are not resident in a EU Member State and do not take the legal form of any Company listed in the Annex to the Directive (See: *Survey of the Implementation of the EC Corporate Tax Directives* 1995 p 363, ed.IBFD). Explaining slightly this position, the latter Report stressed that: "while the exclusion of Gibraltar might not have been intentional, a Member State which does not apply the Directive to Gibraltar Companies may not be held to be in breach of it"; *idem*, p 363.

Then, after an interesting but partial view of the way the different tax authorities are qualifying or disqualifying those companies for the purposes of PSD under the three prong definition of "company of a Member State" in Article 2, the author concludes that the use of a Gibraltar 1992 Company or a Madeira holding company (SGPS) involves risks, being for the latter a minor risk. It is not my intention to start measuring risks. Unfortunately I do not have at my disposal an instrument to evaluate tax risks precisely!

Madeira SGPSs may benefit from specific incentives (as indicated below) but looking through the wide European market I see so many holding or other companies benefiting from tax incentives that I find the above-mentioned conclusions somewhat puzzling.

In my opinion, and this is probably where I differ the most from Bart Rubbens, the applicability of the PSD cannot be refused to pure holding companies (SGPSs) licensed to operate and develop their activity in the Madeira Free Zone (hereinafter "Madeira SGPSs"). Therefore, the following comments will only concern Madeira holding companies.[5]

It is clear that Madeira forms an integral part of Portugal according to the Portuguese Constitution and was included, as well as the archipelagoes of Azores, in Portugal's Accession Act to the EEC. Moreover, according to Portuguese Law, SGPSs must be organised as corporations (SA) or limited liability companies (Lda). These are the two main common categories of commercial companies included under point (k) of the list of companies annexed to the PSD. Therefore, the first two requirements of the said definition in Article 2 of the PSD are completely met and on that I fully agree with Bart Rubbens.

Article 2(c) of the PSD

In this discussion I will deal exclusively with my views on the third requirement of Article 2, which states at paragraph (c) that companies must be "....subject to one of the following taxes, [in Portugal "IRC"][6] without the possibility of an option or of being exempt".

This requirement was not contained in the initial proposal of the Directive of 1969 the scope of which was limited to companies subject to corporate income tax, but subsequent proposals were presented in order to adjust the scheme to the French,

---

5 I will not comment on the applicability of the PSD to other Madeira Companies, including mixed holding companies, and I will not refer to those entities except incidentally (see footnote 15 below). I will not comment on the Gibraltar holding companies either.

6 *Imposto sobre o rendimento das pessoas colectivas.*

Belgian and Portuguese tax systems.[7] In fact, two new conditions were added to the earlier requirement.[8] Henceforth, the fact that those companies must be subject to corporate income tax was not to be enough; later versions state clearly that, in addition, those companies (a) cannot opt to pay corporation tax; (b) nor may they benefit from a corporation tax exemption.

The first requirement (i.e., that the companies must be subject to tax) was not only included in the initial version but was also established in the international tax field

---

7 Otmar Thommes clarifies that "...it soon appeared that some Member States, such as France, subject forms of enterprise other than companies to corporation tax (for example, limited partnerships) or allow other unincorporated forms to opt for corporation tax instead of income tax treatment. This option was available particularly in the case of Belgium .... For these reasons, the description 'being subject to corporation tax' was replaced by a list of taxes and the words 'without the possibility of an option or of being exempt'". (See O Thommes, *EC Corporate Tax Law*, 'Commentary on Article 3 of the Merger Directive' paras 2, 6 and 7). In addition, Fred de Hosson reports further information contained in the Council Minutes, stating that "the subject to tax requirement under Article 2(c) refers ... to holding companies and investment companies not subject to corporate tax in the countries where they have their registered office. It is meant to exclude companies like the Luxembourg holding company (Loi de 3rd Juillet 1929) which are not subject to tax. ... With regard to Spain and Portugal, the Council Minutes further exclude fiscally transparent companies, which are supposed to be subject to tax, but which are in fact exempt if and to the extent that their profits are taxed in the hands of their shareholders. The requirement preventing corporate taxation from being optional refers to a situation which existed until 31st December 1986 in Belgium where a Société de personnes à responsabilité Limitée ("Sprl") was able to opt for fiscal transparency so that the profits of the company were taxed in the hands of the shareholders." Fred de Hosson, 'The Parent-Subsidiary Directive', *The Direct Investment Tax Initiatives of the European Community*, p 35, Kluwer, 1990.

Also Henrique Freitas Pereira, the director of the Portuguese Institute for Fiscal Studies, refers to one observation made in a meeting held on 18th November 1988 by the Portuguese delegation and subsequent French proposals to justify the amendments to the initial proposal of 1969 [see *Ciência Técnica Fiscal nº361/355,* Doc 9774/88 *Fisc 109* of 5th December 1988, Doc 4599/89, Fisc 18, 6th February 1989: Doc 4769/89. *Fisc 24* 22nd February 1989 and Doc 9774/88, *Fisc 109* 5th December 1988].

8 It should also be stressed that paragraph 2 of article 1 (i.e., the anti-abuse provision) did not appear in the initial proposal either.

under a different guise in double tax agreements.[9]

The basic aim of the two new conditions was much less to prevent abuses or frauds by other EC companies than to establish the general characteristics of the companies covered (having regard to the measures and the goals to be adopted to attain avoidance of double economic taxation). In view of the fact that significant corporate tax differences still existed all over the European Market it was important to define whether partnerships or other transparent vehicles could benefit from this régime.

Moreover, one may easily appreciate that the main objective was to avoid double taxation in order to create a genuine internal market not disturbed by tax competitiveness and to put the ultimate shareholders in the same position as the initial ones.

It seems fairly clear that if the company itself is exempt from corporate income tax the PSD cannot apply. Here, again, the neutrality principle is not completely achieved and therefore new measures should be implemented in the future. However, the difficult consensus achieved in the Directive provisions would not be easily challenged. Not only the wording but also the spirit of this requirement was included in Article 2 to deny the applicability of the PSD regime to companies benefiting from exemptions.

In my opinion the Directive does not require that companies must effectively pay taxes to a specified degree. In any event, Member States may deny the applicability of the PSD when it is necessary to prevent frauds and abuses (Article 1(2) of the PSD).

One must not ignore the fact that no EC system for the taxation of corporate income and dividends exists for the time being and it is "extremely unlikely in the foreseeable future that all Member States would be willing to accept the same type of corporation tax system", as noticed by the Ruding Committee. Now, not only the tax rates but also the tax bases are such that it would be possible to find the 'right measure' to tax the different items of income received by a company so as to qualify or disqualify it from the PSD. Being aware of the *status quo*, the EC Member States would certainly have created '*pro rata* provisions' and other objective measures if they had intended to deny the application of the PSD to

---

9 These require first that residents of a contracting state must be liable to tax therein by reason of their domicile, residence, place of management or any other *criteria* in order to qualify for the agreement benefits. After fulfilling this requirement, several other limitations and restrictions arise, such as that the recipient of the dividends is the "beneficial owner" thereof. These cannot enter in the Directive area since "domestic or agreement-based provisions..." cannot restrain the applicability of the PSD, except when "required" for the prevention of fraud or abuse (see Article I).

companies benefiting from any (or certain) tax preferences, incentives or exemptions.

The discussion here is much more comprehensible and interesting in a global scenario. This gives rise to other questions (e.g, should some corporate tax preferences pass through to shareholders?) that would bring us to a discussion of the tax systems themselves, namely the classic system and the different methods of integration. But these points were not in the mind of the EC Member States when Article 2(c) was definitively established.

Madeira SGPSs Tax Régime

Madeira SGPSs — like any other SGPSs incorporated in mainland Portugal — are subject to corporate income tax. Article 41(1) al.g of the Tax Incentives Statute is clear:

> "SGPSs are 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."

This exemption only covers income from non-EU shareholdings. The general tax provision exempting 95% of the income from national and EU shareholdings follows the general corporate income tax position applicable to all Portuguese holding companies.

Madeira SGPSs are subject to tax and must actually pay taxes if they receive dividends from Portugal or from any EC country. In addition, they are subject to corporate income tax and they have to pay it if they realise any capital gains or if they receive any investment income (such as interest from a banking deposit or any loan, including interest deriving from public or private bonds) as well as management fees and other income. Of course, no tax is due if profits are lower than costs.

The sole tax difference between Madeira SGPSs and other Portuguese SGPSs[10] is that the former have a small residue of income exempted from IRC, which is the income (i.e., dividends) from non-EU shareholdings. This difference could be relevant in establishing a Madeira SGPS as the parent company of an non-EU subsidiary but it would not trigger special advantages in the case of an EU holding company.

---

[10] More properly SGPSs incorporated in Lisbon, Oporto or any other place in mainland Portugal or even in Madeira if they do not request a licence to operate in the free zone from the Regional Government of Madeira.

It is true that shareholders of Madeira SGPSs as well as of other Madeira companies may benefit from withholding tax exemptions when the company redistributes dividends (disregarding the specific Double Tax Agreements that may be applicable) but clearly these exemptions do not apply to the Madeira companies, but to the foreign shareholders. Thus, if some measures should be taken by other EC Member States against this kind of situation they should be taken strictly in reliance on Article 1(2) of the PSD ('fraud or abuse' upon which we will comment below) and not be based on Article 2(c). Of course the applicability of Double Tax Agreements may be limited or denied to Madeira companies (see e.g., Article 17(6) of the US-Portugal Treaty) or an ordinary credit method established (see e.g. Article 23 of the OECD Model Convention). These actions would obviously reduce the opportunities created by the Madeira régime although they are of dubious legitimacy.

Other Holding Companies in Europe

It is common knowledge that many European tax incentives and exemptions granted to a wide range of entities are responsible for the fiscal degradation and erosion of corporate income tax. Belgian Co-ordination Centres, Luxembourg "Soparfis" as well as Dutch Holding Companies and the special cases of Irish or Mezzagiorno Italian companies amongst others,[11] benefit from such incentives and exemptions. In view of the fact that these entities are covered by the list attached to the PSD, it has been considered that they meet the PSD requirement in spite of the possibility to claim an exemption for a particular class of income.[12] In spite of their minor differences regarding certain items of income or their origin[13] it seems much easier to find similarities between Madeira SGPSs and these EU holding companies rather than Gibraltar holding companies.

---

11 A general overview on these companies was given by Christian Valendue, 'Tax Havens and Fiscal Degradation in the European Community', *EC Tax Review* [1994] 1 20-25.

12 IBFD commentators suggest that "...this is so even where a company's entire income qualifies for such an exemption". *Survey of the Implementation of the EC Corporate Tax Directives IBFD*, 1995 p 362.

13 Dividends received by SOPARFIS resulting from participations are fully free from income tax and communal business tax on profits provided certain requirements are fulfilled. In addition, dividends distributed by the Soparfis are not subject to withholding tax if distributed to an EC parent company. The treaties also reduce the 15% general withholding tax rate. Dutch holding companies are also exempted on dividends and capital gains realised with the sale of shares.

Exemptions in the Madeira Free Zone

Portuguese law does not allow companies to opt to be subject or not to corporate income tax, just as it does not allow them to apply for exemptions for all types of income whatever the source and the origin, even in the Madeira Free Zone.

The creation and the establishment of the Madeira Free Zone dates from the early eighties and since then its commercial and tax régime has been continuously improved and consolidated.[14]

Unlike many other situations regulated in the Portuguese Incentive Tax Statute, the Madeira exemptions were foreseen as 'automatic exemptions' (i.e., they are not dependant upon a specific request) granted to all those entities previously licensed by the Regional Government of Madeira provided that the several and different requirements established by Article 41 of the Tax Incentives Statute are duly met. However, an exemption is not granted by the Portuguese tax authorities to those entities performing their activity and producing their profits and gains under the umbrella of a licence and therefore companies and their shareholders or other third entities entering in specific business with them must pay special attention to what I call the specific "objective exemptions" i.e., the exemptions relating to income not entities. Otherwise, they could well be surprised by future additional corporate income tax assessments made by the Portuguese tax authorities.

Therefore we may conclude that Madeira SGPS exemption is partial (the majority of income is subject to IRC and other taxes), temporary (up to 2011) and "objective" (i.e., the company itself is not exempt from IRC).[15]

Tax Exemptions, State Aids or EC Economic and Social Cohesion?

During the negotiations undertaken to join the EEC, Portugal presented requests to maintain or increase some regional and government incentives to develop not only specific industries but also some regions such as Azores and Madeira. In the latter case a common declaration concerning the social and economic development of the Autonomous Regions of Azores and Madeira was signed, pointing out that

---

14 Until 1st January 1989 the tax incentives applying to the Madeira Free Zone were regulated by Decree-Law 165/86 of 26th June. By 1989 the tax exemptions were redefined in the new "Tax Incentives Statute" (articles 41 and 50(1)(g)) approved by Decree-Law 215/89 of 1st July, but minor incentives remain in the old framework.

15 Even for mixed holding companies one may argue that exemptions are temporary, partial and objective in spite of the additional difficulties that may arise if one has to say that those companies are not only liable to tax but that they are effectively subject to tax to some degree.

the Community institutions should pay special attention to those Regions.[16] The European Commission decided on 26th June 1986 not to raise any objections to the Madeira tax exemptions (created by Decree-Law 165/86 of 26th June) for a period of three years.[17]/[18]

Subsequently, the Commission made further investigations to find out if such aids were still necessary to develop the regions or were being misused. In 1986, 1989, 1991 and 1994 the Commission considered that those aids were not only necessary but should be seen as compatible with the Common Market because they do not violate Community state aid rules (Article 92 EC Treaty) and they are not in violation of free competition.

Furthermore, notwithstanding their express intention to avoid recommendations regarding tax incentives, the Ruding Committee recognised that they may still be necessary in some cases such as Madeira's (in order, e.g., to accelerate economic development in certain regions).

Therefore, it is very well understood that these specific tax advantages were motivated by political, social and economic reasons which are still playing an important role in the construction of an homogeneous Europe. In this context it seems absurd that other EC Member States adopt internal measures to discriminate against the companies in question.

Concluding Remarks

First of all, it is crystal clear that Madeira Companies cannot be considered en bloc because completely different tax régimes apply to them. All the companies are liable to corporate income tax and all of them may benefit from specific "objective" exemptions. But some of them (e.g., mixed holding companies) may

---

16 This Declaration may be found in *Tratado de Adesão de Portugal e Espanha as Comunidades Europeias*, Vol III p 182, Comissão e Secretariado para a Integraçâo Europeia, ed IN-CM, Setembro 1985.

17 See: Maria Margarida Cordeiro Mesquita, 'O Regime Comunitário: Dos Auxilios de Estado e as suas implicações em sede de benefícios fiscais', ed CEF, *Cadernos da CTF* (158) p 62, footnote 85.

18 The description of these tax incentives with their subsequent amendments may be found in Arnold Sherman, 'Madeira - The Unknown Tax Haven', *Intertax* (1989) 12 at 530; Miguel Garcia Caballero: 'Portugal - The New Tax Incentive Statute', 29 *European Taxation* 9 (1989) at 304; Francisco de Sousa da Câmara, 'Madeira Free Zone: The Exemptions and Financial Incentives', 30 *European Taxation* (1990) at 87, and also from the latter author 'Madeira Free Zone Legislation Amended', 34 *European Taxation* 1 (1994) at 2; Anni Laukkanen, *Madeira Offshore Centre and Tax Incentives,* Helsinki School of Economics and Business Administration, Helsinki 1994.

benefit from a much broader class of exempt income items than others (e.g., SGPSs).

I finished the first part of these comments by concluding that Madeira SGPSs cannot be seen differently from other European holdings and that the PSD applicability cannot be refused to them. Of course, there are now other powerful reasons to forbid tax discrimination against those Madeira SGPs which, otherwise, would be in a weaker position than other European entities (e.g., those in the Netherlands, Luxembourg or Belgium) where they have a European subsidiary.

Secondly, Member States may adopt "...domestic or agreement based provisions required for the prevention of fraud or abuse" but we should not ignore the need to respect the term "required." Thus, in my opinion, the foreign tax authorities must prove the fraud or the abuse of using Madeira SGPSs in order to deny the PSD applicability in a case by case situation.[19]

Finally, I cannot resist recalling that individual Member States cannot put themselves above the European Commission and see violation of competition or fraud and abuse in the incorporation of foreign holding companies in tax free regional zones such as Madeira and start behaving like European guardians. Even if tax competition increases and the oligopoly in the holding companies' market is challenged, an individual Member State's public statement excluding particular companies from the PSD qualification (I would say from the European market) is not acceptable, if no detailed reasons or justifications are put forward.

Recently I had the immense pleasure of seeing a beautiful and fascinating exhibition at the Metropolitan Museum of Art called "Rembrandt/Not Rembrandt". It is well known that there are many Rembrandt imitations but it is also unlikely that the problems concerning Rembrandts will ever be solved. However, it does not seem serious or even polite to enter a lucky owner's house or a museum and start shouting that this Rembrandt is a forgery...

It would not be fair, would it?

---

[19] As stressed by Otmar Thommes "any simplifying formula leading to a presumption of fraud or abuse, even if rebuttable, would not be in accordance with the meaning of the terms "required" under paragraph 2", *EC Corporate Tax Law* 'Commentary on the Parent Subsidiaries Directive' - article 1 para 25, 1992.