

Outline of the tax incentives for operating in the

Madeira Free Trade Zone

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INDEX

1 - Introduction - Origin and areas of activity covered by the Madeira Free Trade Zone (MFTZ)

2 - Operating in the MFTZ

2.1. - Basic legal framework for the MFTZ

2.2. - The MFTZ' areas of activity

2.2.1. - International Services

2.2.1.1. - Types of tax-efficient corporate vehicles available in the MFTZ

2.2.1.2. - Incorporation/registration requirements and tax benefits applicable to such vehicles

2.2.1.2.1. - Pure holding companies

2.2.1.2.2. - Mixed holding companies

2.2.1.2.3. - Trusts

2.2.2. - Financial Services

2.2.2.1. - Incorporation and operation of credit institutions, financial companies or insurance companies or branches thereof in the MFTZ

2.2.2.2. - Specific tax benefits and requirements applicable to credit institutions, financial companies and insurance companies operating in the MFTZ

2.2.2.3. - Specific requirements applicable to credit institutions, financial companies and insurance companies

2.2.3. - The Industrial Free Trade Zone

2.2.4. - International Shipping Register (MAR)

3 - Specific tax regulations applicable to MFTZ

- 3.1. - Specific tax benefits (other than income tax exemptions)
- 3.2. - VAT rules applicable to the MFTZ
- 3.3. - Double taxation treaties in force

1 - Introduction

Origin and areas of activity covered by the Madeira Free Trade Zone (MFTZ)

1.1. Origin

The Madeira Island is the larger of the two islands (Madeira and Porto) comprised in the Madeira archipelago, about 700 km off the Northwest African coast.

The Portuguese government authorised in 1980 the creation of free trade (i.e., tax-exempt) zones in Madeira and in the Santa Maria island (Azores archipelago) with a view to stimulate social and economic development in these peripheral regions. In 1986, a framework of specific tax benefits for the Madeira Free Trade Zone (*Zona Franca da Madeira*) was enacted.

Following Portugal's accession to the European Union, the specific Madeira and Santa Maria tax benefits thus created were acknowledged as temporary regional aid schemes for ultraperipheral regions. Nonetheless, even though under recent amendments to corporate income taxation rules companies licensed after 1 January 2001 may be subject to taxation, there are EU concerns that the aforesaid benefits may be in breach of EU State Aid rules and EU Commissioner Mario Monti is leading an investigation on the issue. Portuguese authorities, however, remain supportive of the Madeira Free Zone tax benefits and currently there are

hopes that the abovementioned investigation may have an outcome favourable to Madeira and Portugal.

The purpose of this paper is to outline the current tax benefits applicable to the Madeira Free Trade zone.

Offshore activities in the Madeira Free Trade Zone, also known as the Madeira International Business Centre (MIBC), spread over four areas:

- a) *International Services* - a broad definition given to the MTFZ area dedicated to trading, holding, trust managing, consulting, and other service companies,
- b) *Financial Services* - the services provided by credit institutions, financial companies, and insurance companies or branches thereof to operate in the MFTZ,
- c) *The Industrial Free Trade Zone (Zona Franca Industrial)* - which aims at developing Madeiran industry by attracting manufacturing businesses to Madeira Island by granting them specific tax benefits,
- d) *The International Shipping Register (Registo Internacional de Navios da Madeira - MAR)*, created in 1989 as an alternative to other international registers.

2 - Operating in the MFTZ

2.1. Basic legal framework

Operating in the MFTZ is subject to the following regulations:

- a) Decree-Law 500/80, of 20 October 1980, creating free trade zones in the Madeira and Santa Maria Islands,
- b) Decree-Law 165/86, of 26 June 1986, laying out the tax benefits and exemptions applying to entities operating in the MFTZ,
- c) Articles 33 and 34 of the Tax Benefit Code, as approved by Decree-Law 215/89, of 1 July 1989, last amended by Law 109-B/2001 of 27 December 2001, laying down the corporate income tax (*Imposto sobre o Rendimento das Pessoas Colectivas* - IRC) exemptions and/or reductions applying to entities operating in the MFTZ,
- d) *Portaria* (Governmental Order) no. 555/2002, of 4 June 2002, establishing the criterion for the application of corporate income tax exemptions to financial institutions that do not operate solely in the Madeira and Santa Maria Free Trade Zones and *Portaria* (Governmental Order) no. 360/2002, of 5 April 2002, establishing the accounting standards applicable to financial institutions that do not operate solely in the Madeira and Santa Maria Free Trade Zones for the purpose of applying MFTZ corporate income tax exemptions,
- e) *Portaria do Governo Regional da Madeira* (Madeira Regional Government Order) no. 222/99, of 28 December 1999, setting forth the establishment, incorporation and operation fees payable by entities licensed to operate in the MFTZ,
- f) Decree-Law 234/88, of 5 July 1988 (as amended by Decree-Law 50/95, of 16 March 1995 and Decree-Law 225/95, of 8 September 1995), creating the MFTZ registry and notary offices, and Decree-Law 212/94, of 10 August 1994, laying down rules regarding the notices to be published by

corporate entities operating in the MFTZ and authorising the incorporation of sole shareholder companies in the same zone,

g) Decree-Law 10/94, of 13 January 1994 (as amended by Decree-Law 307/95 of 20 November 1995) laying down the incentives and requirements for the incorporation of financial institutions in the MFTZ,

h) *Decreto Regulamentar* (Regulatory Decree) 53/82, of the 23 August 1982, and *Decreto Regulamentar Regional* (Regional Regulatory Decree) 21/87/M, of 5 September 1987 (as amended by Regional Regulatory Decree 23/95/M, of the 31 August 1995), laying down rules regarding the activities carried out within the Industrial Free Trade Zone,

i) Decree-Law 352-A/88, of 3 October 1988 (as amended by Decree-Law 264/90 of 31 August 1990), and Decree-Law 149/94, of 25 May 1994, laying down the rules on the incorporation, registration and operation of trusts or branches of offshore trusts within the MFTZ,

j) Decree-Law 96/89, of 28 March 1989 (as amended by Decree-Laws 393/93, of 23 November 1993, 5/97 of 9 January 1997, and 331/99, of 20 August 1999), and *Portaria* (Governmental Order) no. 715/89 of 23 August 1989, creating the Madeira International Shipping Registry (*Registo Internacional de Navios da Madeira – MAR*),

k) *Portaria do Governo Regional da Madeira* (Madeira Regional Government Order) no. 134/92, of 20 May 1992 (as amended by *Portarias do Governo Regional da Madeira* (Madeira Regional Government Orders no. 14/97, of 5 May 1997, no. 180/99, of 25 October 1999, and no. 227/99, of 29 December 1999), laying down the registration fees charged at the MAR,

l) *Portaria do Governo Regional da Madeira* (Madeira Regional Government Order) no. 135/94, of 1 August 1994 (as amended by *Portaria do Governo Regional da Madeira* (Madeira Regional Government Order) no. Order 227/99, of 29 December 1999), laying down the fees for registering leisure yachts at the MAR.

2.2. The MFTZ's areas of activity

2.2.1. International Services

2.2.1.1. Types of tax-efficient vehicles available in the MFTZ

Within the International Services area, operators can make use of a number of corporate vehicles adequate to take advantage of all the tax benefits granted to the MFTZ:

- Pure holding companies
- Mixed holding companies
- Trusts

2.2.1.2. Incorporation/registration requirements and tax benefits applicable to such vehicles

2.2.1.2.1. Pure holding companies

(i) *Definition* - Pure holding companies (*Sociedades Gestoras de Participações Sociais - SGPS*) are companies whose corporate object consists solely of managing holdings in other companies. Only shareholdings over 10% of the share capital of the company the pure holding company invests in, held for at least one year, are deemed to be relevant for the pure holding company's corporate object. Pure holding companies are prohibited from disposing of, or encumbering, their shareholdings less than a year after its

acquisition, except where these were acquired by exchange or where the respective capital gains are reinvested within 6 months, neither can they own immovable assets except for their own premises nor grant loans to companies other than ones they invest in.

(ii) *Incorporation* - Pure holding companies must be incorporated under the legal form of corporation (*sociedade anónima*) or private limited quota company (*sociedade por quotas*) and their corporate name must bear the expression *Sociedade Gestora de Participações Sociais* or *SGPS*.

(iii) *Tax benefits and exemptions* – until 2011, pure holding companies enjoy the following tax benefits:

(a) Full exemption from corporate or individual income tax with regard to the dividends and capital gains arising from holdings in non-EU subsidiaries without a permanent establishment in Portugal (except those located in free trade zones);

(b) As regards the dividends paid by EU or Portuguese-resident subsidiaries, they are liable to tax, however, under the Tax Benefit Code pure holding companies are allowed to deduct the totality of such dividends to their taxable income, which in practice is tantamount to a tax exemption on those dividends;

(c) As regards capital gains arising from holdings in EU or resident companies, 50% thereof are tax-deductible provided that they are reinvested in shareholdings in resident companies or in Government bonds in the financial year prior to the one in which those gains were obtained, in the same year or in the two financial years thereafter;

(d) No withholding tax applies to dividends paid by resident subsidiaries and those paid by EU subsidiaries may also be

exempt from withholding tax, as Madeiran pure holding companies are in a position to qualify as parents companies for the purposes of Council Directive 90/435/EEC of 23 July 1990 (the Parent/Subsidiary Directive), although that may require a case-by-case study since such qualification is not accepted unanimously throughout the other EU jurisdictions;

(e) Dividends paid by Madeiran pure holding companies to their non-resident subsidiaries are exempt from individual or corporate income tax.

Nonetheless, the income obtained by pure holding companies licensed to operate in Madeira after 2001 shall be taxed by way of corporate income tax at 1% if licensed in 2001 and 2002, 2% if licensed in 2003 and 2004 and 3% if licensed in 2005 and 2006.

2.2.1.2.2. Mixed holding companies

(i) *Definition* - mixed holding companies are companies whose corporate object consists both of trading on their own right and holding and managing shareholdings in other companies; pursuant to the Portuguese Companies Code, the holding and managing shareholdings in other companies must be expressly authorised in the company's Articles of Association.

(ii) *Legal Forms* - A mixed holding company can be incorporated under any of the legal forms provided for in the Portuguese Companies Code, among them, the corporation (*sociedade anónima*), the private limited quota company (*sociedade por quotas*) and the sole quotaholder company (*sociedade unipessoal por quotas*);

(iii) *Incorporation requirements* - a mixed holding company must be incorporated with at least 5 shareholders and a minimum €50,000 share capital, or 2 shareholders and a minimum €5,000 share capital, or 1 shareholder and a minimum €5,000 share capital,

if it is incorporated under the form of corporation, private limited quota company or sole quotaholder company, respectively; under Decree-Law 212/94, of 10 August 1994, corporations licensed to operate in Madeira can also be incorporated with a single shareholder;

(iv) Tax benefits and exemptions - until 2011, mixed holding companies enjoy the following benefits and exemptions:

(a) The profits obtained by mixed holding companies are exempt from corporate income tax, provided that they arise from operations carried out with entities established within the MFTZ or with non-resident entities (whether located within the EU or not) without a permanent establishment in Portugal;

(b) The interest paid by mixed holding companies operating in the MFTZ in respect of loans made by them is also exempt of corporate income tax, provided that such loans were intended for investing within the MFTZ, or providing for the company's regular operation, and the grantor is non-resident;

(c) Dividends paid by Madeira mixed holding companies to non-resident shareholders are exempt from corporate or individual income tax, and so is the interest paid the company in respect of loans or advances granted by non-resident shareholders.

2.2.1.2.3. Trusts

(i) Definition - a trust is a vehicle to which a person or entity (the settlor) allocates certain assets, to be managed by one or more persons (trustees) on behalf of the settlor himself or of a third person (beneficiary) and was introduced in the Portuguese legal system by Decree-Law 352-A/88, of 3 October 1988 as a means to further stimulate operations in the MFTZ' International Services area;

(ii) Offshore trusts - The aforesaid Decree-Law only allows the incorporation of offshore trusts, those where (a) both the settlor and the beneficiary are non-resident entities (licensed to operate within the MFTZ or not), (b) the immovable assets allocated thereto are located outside Portugal, (c) their income arises from funding from non-resident entities (except bank deposits made with non-resident credit institutions operating within the MFTZ), and (d) the law applicable to the trust is expressly chosen by the settlor;

(iii) Incorporation requirements - the trust must be incorporated through a written document, which must be signed by the settlor or by the trustee on his behalf (whose signature must also be certified by a notary) and contain, *inter alia*, full identification of trust, settlor, trustees and beneficiary, an indication of the type, purpose and assets of the trust, the trust's management regulation and an indication of the law applicable to the trust;

(iv) Registration and fees - MFTZ offshore trusts must be registered (however, the identification of the settlor and beneficiary is secret and can only be disclosed under a Court order) and its incorporation and registration is subject to the payment of an annual fee;

(v) Trust companies and branches - the incorporation and operation of trust branches or trust companies within the MFTZ is also allowed - except for under authorisation by the Madeiran Regional Government (*Governo Regional da Madeira*) and subject to the payment of an incorporation fee and an annual operation fee;

(vi) Tax benefits and exemptions - trusts and trust branches and companies enjoy the following benefits/tax exemptions:

(a) Trusts are exempt from corporate or individual income tax with respect to income arising from operations carried out with entities established within the MFTZ or with non-resident

entities (whether located within the EU or not) without a permanent establishment in Portugal;

(b) The interest paid in respect of loans made by trusts and trust companies or branches is also exempt of corporate income tax, provided that such loans were intended for investing within the MFTZ, or providing for the trust or trust branch or company's regular operation, and the grantor is a non-resident entity;

(c) Income paid by trust branches or companies to clients established in the MFTZ or residing outside Portugal are exempt from corporate or individual income tax;

(d) Repatriation of invested capital and profits, transfer of funding for trade operations and funding imports are unrestricted.

(vii) Restriction to offshore trust activities - MFTZ trusts, trust companies or trust branches are not allowed to undertake financial activities.

2.2.2. Financial Services

2.2.2.1. Incorporation and operation of credit institutions, financial companies or insurance companies or branches thereof in the MFTZ

The development of the Madeiran economy also involved opening the MFTZ - and the tax benefits attached thereto - to financial services.

Thus, Decree-Law 10/94 of 13 January 1994 allowed the incorporation and operation of credit institutions (banks, investment companies, leasing companies, factoring companies, etc.), financial companies (dealers, brokers, investment fund managing companies,

venture capital companies, etc.) and insurance or reinsurance companies, as well as the incorporation and operation of branches of such companies, in the MFTZ.

The incorporation and operation of such companies must comply with the procedures and requirements laid down, respectively, by the Portuguese legal framework for credit institutions and financial companies (Decree-Law 298/92, of 31 December 1992, as amended) and the legal framework for insurance and reinsurance companies (Decree-Law 94-B/98 of 17 April 1998, as amended).

MFTZ credit institutions/financial companies and insurance companies must also be authorised by the *Banco de Portugal* (Central Bank of Portugal) or by the *Instituto de Seguros de Portugal* (Insurance Supervisory Authority), respectively.

2.2.2.2. Specific tax benefits applicable to credit institutions, financial companies and insurance companies operating in the MFTZ

Credit institutions, financial companies and insurance companies authorised to operate in the MTFZ in 2000 or before benefit from the following tax exemptions, until 2011:

a) Credit institutions and financial companies - full exemption of corporate/individual income tax in respect of income arising from operations carried out within the MFTZ, provided that these operations involve non-resident entities only (and the latter are not subsidiaries of, or controlled in any form by, credit institutions residing in Portugal but outside the MFTZ).

b) Investment fund managing companies - full exemption of corporate/individual income tax in respect of income arising from the management of funds at least 90% of whose assets are invested outside Portugal and whose participation units were acquired by non-resident entities only.

c) Insurance companies - full exemption of corporate/individual income tax, provided they operate only within the MFTZ or with non-resident entities (non-Life Insurance) or with non-residents only (life assurance).

From 2001 onwards, the income thus exempt is taxed by way of corporate income tax at reduced rates, as follows:

- Credit institutions and financial companies: 7,5% if authorised in 2001 and 2002, 10% if authorised in 2003 and 2004 and 12,5% if authorised in 2005 and 2006,

- Investment fund management companies and insurance or reinsurance companies: 1% if authorised in 2001 and 2002, 2% if authorised in 2003 and 2004 and 3% if authorised in 2005 and 2006.

As regards credit institutions and financial companies operating neither exclusively nor predominantly within the MFTZ, from 1 January 2003 onwards 80% of their income shall be deemed to have been obtained outside the MFTZ and shall therefore be taxed at normal rates, as per *Portaria* (Governmental Order) no. 555/2002, of 4 June 2002.

2.2.2.3. Specific requirements applicable to credit institutions, financial companies and insurance companies

In order to take advantage of the above described tax benefits/reductions, credit institutions, financial companies and insurance companies must prove that the entities they operate with are non-resident, as follows:

(a) Wherever those entities are central banks or entities governed by public law, credit institutions, financial companies, investment funds or insurance companies based in an OECD country, by means of

- their respective tax card number, wherever possible, or
- a certificate issued by the competent registration or supervisory authority proving that the entity in question was duly incorporated in accordance with the relevant laws and containing the entity's domicile, or
- A formal statement duly signed and authenticated (for central banks and central banks or entities governed by public law only),

(b) Wherever those entities are Portuguese emigrants, by means of the documents required to open a savings account for emigrants in a Portuguese bank,

(c) In all other cases, by means of a certificate (the original or an authenticated copy thereof) of the entity's residence issued by the competent governmental or tax authorities or by a Portuguese consulate, but not more than three years before or three months after the operations in question, which is valid for the whole course of the operation, provided that it lasts no more than a year.

From 1 January 2003 onwards, credit institutions and financial companies operating neither exclusively nor predominantly within the MFTZ shall be required to keep separate accounts, subject to specific accounting requirements, for the operations carried out within the MFTZ.

2.2.3. The Industrial Free Trade Zone

Manufacturing businesses licensed to operate in the Madeira Industrial Free Trade Zone (MIFTZ) benefit, *inter alia*, from the following tax exemptions:

- a) Full exemption, until 2011, of corporate and/or individual income tax on profits and dividends,
- b) Full exemption of tax payable on the transfer of immovable assets (“Sisa”) and/or Inheritance and Gift Tax in respect of immovable assets acquired within the MIFTZ by manufacturing businesses for their premises,
- c) Full exemption of import duties on certain categories of raw materials to be processed at facilities located in the MIFTZ, pursuant to Council Regulation (EC) no. 122/96 of 22 January 1996 and Commission Regulation (EC) no. 1482/97 of 28 July 1997.

2.2.4. - International Shipping Register (MAR)

The Madeira International Shipping Register (MAR) encompasses the registration of cargo and/or passenger transport ships (including fixed or floating oil rig platforms) and pleasure yachts.

The MAR combines the safety and technical standards applicable to conventional shipping registers with a number of tax exemptions and benefits (applicable until 2011), thereby turning the MTFZ an attractive option for shipping activities.

Those tax exemptions and benefits are the following:

- (a) Income arising from maritime transport activities is exempt from corporate or individual income tax, except where it relates to cargo and/or passenger transportation between Portuguese ports;
- (b) Remunerations paid to crews registered with the MAR are exempt from individual income tax.
- (c) Shipping companies also enjoy all the other benefits and exemptions applicable to entities operating within the MFTZ (see 3.,1, below).

3 - Other Tax benefits and exemptions applicable to the MFTZ

3.1. - Specific tax benefits (other than income tax exemptions)

Apart from the corporate and/or individual income tax exemptions described in preceding sections, entities operating in the MFTZ enjoy an array of financial and tax benefits:

- (a) No restriction applies to foreign entities licensed to operate within the MFTZ as regards the repatriation of invested capital and profits, transfer of funding for trade operations and funding imports;
- (b) Full exemption of tax payable on the transfer of immovable assets (“Sisa”) and/or Inheritance and Gift Tax in respect of immovable assets acquired to serve as their premises;
- (c) Exemption of corporate or individual income tax on capital gains arising from the sale of construction land kept as reserve;
- (d) Exemption of Municipality Tax (*Contribuição Autárquica*) and of all local taxes and surtaxes;
- (e) Exemption of stamp duty with regard to all books, papers, documents, contracts covered by the Stamp Duty Code, except where they relate to operations carried out with entities residing in Portugal but outside the MFTZ or non-resident entities with a permanent establishment in Portugal.

3.2. VAT rules applicable to the MFTZ

Transactions located at the Madeira Island are value-added taxed under reduced rates (4%, 8% and 13%), which makes the Madeira Island the most favourable area in Europe as VAT is concerned.

3.3. Double Tax Treaties

The tax exemptions and benefits described in the preceding sections can be further complemented with the double tax treaties entered into by Portugal, which fully apply in MFTZ. The double tax treaties concluded by Portugal as well as the maximum withholding tax rates applicable are listed in the chart below.

DOUBLE TAX TREATIES

COUNTRIES	DATE RATIFIED	RATES		
		DIVIDENDS	INTEREST	ROYALTIES
AUSTRIA	1971	15%	10%	10% c) 5% b)
BELGIUM (1)	1970	15%	15%	5%
BRAZIL	2001	10% e) 15% b)	15%	15%
BULGARIA	1996	10% e) 15% b)	10%	10%
CANADA	2000	10% e) 15% b)	10%	10%
CAPE VERDE	2000	10%	10%	10%
CHINA	2000	10%	10%	10%
CUBA (2)	2001	5% e) 10% b)	10%	5%
CZECH REPUBLIC	1997	10% e)	10%	10%

		15% b)		
DENMARK (3)	2002	10% i)	10% j)	10%
FINLAND	1970	10% e) 15% b)	15%	10%
FRANCE	1971	15%	10% f) 12% b)	5%
GERMANY	1982	15%	10% a) 15% b)	10%
GREECE (2)	2002	15%	15%	10%
HUNGARY	1999	10% e) 15% b)	10%	10%
ICELAND (3)	2002	10% e) 15% b)	10% j)	10%
INDIA	2000	10% e) 15% b)	10%	10%
IRELAND	1994	15%	15%	10%
ITALY	1982	15%	15%	12%
LUXEMBOURG	2000	15%	10%(h) 15%(b)	10%
MACAO	1999	10%	10%	10%
MALTA (3)	2002	10% e) 15% b)	10%	10%
MEXICO	2000	10%	10%	10%
MOROCCO	1998	10% e) 15% b)	12%	10%
MOZAMBIQUE	1992	15%	10%	10%
NORWAY	1970	10% e) 15% b)	15%	10%
POLAND	1997	10% e) 15% b)	10%	10%
ROMANIA	1999	10% e) 15% b)	10%	10%
RUSSIA (2)	2002	10% e) 15% b)	10%	10%
SINGAPORE	2000	10%	10%	10%

SOUTH KOREA	1997	10% e) 15% b)	15%	10%
SPAIN	1995	10% e) 15% b)	15%	5%
SWITZERLAND	1974	10% e) 15% b)	10%	5%
THE NETHERLANDS	2000	10%	10%	10%
TUNISIA	2000	15%	15%	10%
UKRAINE (3)	2002	10%(e) 15%(b)	10%(j)	10%
UNITED KINGDOM	1968	10% e) 15% b)	10%	5%
UNITED STATES OF AMERICA	1995	10%(e) 15%(b)	10%	10%
VENEZUELA	1997	10%	10%	12% e) 10 % g)

(1) Amended by an additional Convention ratified by Portugal in 14th December 2000;

(2) Not yet in force.

(3) The treaty is already in force but its provisions are only effective as of 1 January 2003

a) If paid by banking entities;

b) In all other cases.

c) Where a company holds 50% or more of the share capital.

d) Literary, artistic or scientific works, films, etc.

e) Where a company holds 25% or more of the share capital for two consecutive years.

f) In respect of debentures issued in France after 1st January 1965.

g) For the supply of technical assistance services.

h) If paid by companies to financial entities.

i) No withholding tax shall apply if paid by a company to its subsidiary, provided that the former holds a 25% or higher participation in the latter's share capital for, at least, two consecutive years.

j) No withholding tax shall apply if paid by, or to, one of the contracting parties, a political subdivision, a municipality, the Central Bank or any public institution.