MADEIRA

SOME REFLECTIONS ON PORTUGAL'S NEW TAX TREATY WITH CANADA

INTRODUCTION

Canada and Portugal signed their first tax treaty on June 14, 1999. It took a long time to negotiate. The first indication of negotiations was a Canadian announcement in April 1973. One hopes that it will not take another 26 years to ratify the new treaty.

Portugal has run into some tax treaty problems with other countries because of the tax benefits offered in Madeira. Portugal's tax treaty with Denmark was unilaterally terminated on January 1, 1995 by Denmark, and Brazil gave notice of termination of its tax treaty with Portugal, effective January 1, 2000. In each case, the reason was related to what was considered to be the inappropriate use of Madeira companies to reduce or eliminate Danish/Brazilian withholding taxes.

COMPARISON WITH OTHER PORTUGUESE TAX TREATIES

Article 27(3)[1] of the Canada-Portugal treaty is an interesting departure from the "normal" tax treaty provisions of each country. As explained in more detail below, it excludes Madeira corporations from the benefits of the Canada-Portugal treaty, except in special circumstances.

The only provision in any of Portugal's tax treaties which entirely excludes Madeira entities is the Portugal-USA treaty. Article 17(5) (Limitation on Benefits) names Madeira entities as specifically excluded from the benefits of the treaty.

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[1] This subsection reads as follows:

3. Notwithstanding the provisions of Article 4, a company or other entity that is entitled to income tax benefits under the legislation and other measures relating to the tax-free zones of a Contracting State, or to benefits similar to those provided with respect to such tax-free zones that are made available under any legislation or other measure adopted after the date of signature of the Convention, shall be deemed not to be a resident of that State for the purposes of the Convention. However, this paragraph shall not apply to a company or other entity deriving income from:
   (a) an active trade or business in that State, the selling of goods or merchandise in that State or the rendering of services, other than services referred to in subparagraph (b), in that State, or
   (b) the rendering of services offered in the ordinary course of business by a bank, an insurance company, a registered securities dealer or a deposit-taking financial institution, if at least 75 per cent of its income from all sources is taxed under the ordinary rules of the tax law of that State.

COMPARISON WITH OTHER PORTUGUESE TAX TREATIES, Cont'd

Other recent treaties concluded by Portugal, such as that with the People's Republic of China in 1998, and those with Iceland, the Netherlands and Venezuela in 1999, do not restrict the use of Madeira, even in coded language ("…the tax-free zones of a Contracting State,"). The wide variation in the attitude taken by Portugal's treaty partners towards Madeira is a little unusual.

TREATY BENEFITS FOR CANADIANS

The effect of Article 27(3) of the Canadian treaty on the ability of certain Canadian corporations to reduce their total tax burden is startling. Available methods include carrying on an active trade or business, selling goods or merchandise, and the rendering of certain services, in Madeira. That provides a great deal of scope for Canadian businesses to save Canadian tax.

Article 3(2) of the Canada-Portugal treaty may result in "an active trade or business" being defined for the purposes of the treaty by using the definition of "active business" contained in the Canadian Income Tax Act. This is a complex definition, beyond the scope of this article. It excludes a number of activities which are within a common-sense definition of an active business, such as offshore purchasing and most investment dealing activities.

An entity carrying on activities in Madeira other than those specified in Article 27(3) is outside the scope of the Canada-Portugal treaty. This result is achieved by deeming a Madeira entity carrying on non-specified activities not to be a resident of Portugal for purposes of the treaty. The treaty applies only to residents (Article 1). For example, the use of a Madeira subsidiary company of a Canadian parent just to earn "passive" income will take the Madeira subsidiary out of the treaty, because it will be deemed not to be a resident of Portugal.

AN EXAMPLE

How can a Canadian manufacturer take advantage of this new treaty? Consider a hypothetical example:

A Canadian corporation has a division which manufactures widgets in Ontario. It exports almost all its production to countries in the European Union. The corporation's world-wide income is subject to Canadian corporate tax on the first Cdn $200,000 of taxable income at the rate of about 21%, the balance being taxed at about 36%.

AN EXAMPLE, Cont'd

The corporation transfers its widget manufacturing business to a subsidiary incorporated in the Industrial Free Trade Zone of Madeira. The tax result? No Portuguese tax on the manufacturing business until the end of 2011, no withholding tax on dividends, interest or royalties, and no Canadian tax on the parent's dividend income. Furthermore, under current Canadian tax legislation, if the Canadian company finances the cost of the move to Madeira and provides the Madeira company with working capital through borrowings, interest paid on the loans will be deductible from other taxable income of the Canadian parent.

Transfer pricing issues may arise in respect of machinery etc. transferred from the Canadian parent company, or if the Madeira subsidiary purchases raw materials or components from its parent.

The Madeira authorities anticipate that the tax benefits, due to expire on December 31, 2011, will be extended, perhaps with some modifications. All tax benefits must be approved by the European Union.

The dividend income from Madeira is exempt from Canadian tax because it is deemed to come from the "exempt surplus" of the Madeira subsidiary. Exempt surplus is defined as income earned by an active business being carried on by a foreign affiliate resident in a country with which Canada has a comprehensive double tax treaty in effect. The legislation also provides that, when a Canadian tax treaty is ratified, the starting point for the exemption is backdated to the date the treaty was signed, in this case June 14, 1999. Canadian legislation in this area is very complex; this paragraph is an over-simplification.

SHOULD THE TAX TAIL WAG THE DOG?

Tax should never be the only driving force in a decision to make such a drastic change in business activities. Other points are critical - for example: availability and cost of suitable premises; quality and cost of the workforce; acceptable means of transportation of raw materials in, and finished goods out; accessibility; communications; language; possible problems with the bureaucracy; and so on. Only when the non-tax questions have been satisfactorily answered should there be consideration of a move.

WILL THE TREATY BE RATIFIED?

In both Canada and the United States, politicians have recently paid a great deal of attention to, and made a great deal of noise about, the transfer of domestic manufacturing to countries with much lower cost and tax structures. It is fascinating to see Canada signing a tax treaty that will encourage such transfers.

The new treaty must be approved by both Houses of the Canadian Parliament as part of the ratification process. The good news is that there are only a few members of either the House of Commons or the Senate who are likely to understand the implications of the treaty when it is presented to them as part of a ratifying Bill. In any event, proposals to Parliament by the Canadian Government are almost always approved.

The only time in recent years that ratification of a Canadian treaty was refused was the Canada-Liberia tax treaty, signed in 1976, but never ratified. In fact, after it was presented to Parliament and withdrawn, the then Minister of Finance announced that the treaty with Liberia would not be ratified.

It is hoped that the Canada-Portugal treaty will slide smoothly through the Canadian ratification process; ratification problems in Portugal seem unlikely.

A LESSON TO BE LEARNED?

I believe there is a lesson to be learned here. International tax practitioners should always review newly signed tax treaties if they have clients in even one of the two jurisdictions. Look for something your clients may be able to use, and you may find it.

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