CORPORATE TAX PLANNING USING MADEIRA:

A LOW TAX JURISDICTION WITHIN THE EUROPEAN UNION

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Madeira is an island in the Atlantic Ocean about 1,000 km southwest of Lisbon and about 600 km west of the Moroccan coast, with a population of over 250,000. It is part of Portugal. In 1425, the King of Portugal made Madeira a full province of Portugal, and it has been an autonomous region of Portugal since 1976. Madeira is therefore inside the European Union (EU) and has its own special tax regime, approved by the EU.

The Madeira tax regime presents some fascinating possibilities. There are no withholding taxes on outgoing dividends, interest or royalties, no capital gains taxes and no stamp duties on capital. The benefits of the EU Parent/Subsidiary Directives are available to companies resident in Madeira.

There are two income tax regimes currently effective in Madeira.

The former regime – zero income tax on most corporations until 2011 – can be used by any corporation that was incorporated and licensed in Madeira by the year 2000. Hundreds of such corporations are available for purchase from local management companies.

The new regime provides for a corporate tax rate of one per cent for corporations licensed in 2003 or 2004, increased to two per cent for 2005 and 2006 and to three per cent for corporations licensed from 2007 through 2011. Certain conditions have to be fulfilled in order to be granted these tax benefits. There are some restrictions. For example, the new regime is not applicable to financial corporations, nor to coordination centres for multinationals. The “old” corporations are much more useful.

Negotiations are under way with the EU to extend the low tax period past the current deadline of 2011. The outcome is uncertain.

Another significant tax advantage of Madeira is that the value added tax (VAT) rate is 15%, one of the lowest rates in the EU. VAT rates in the EU range up to 25%. This has resulted in Madeira becoming a favourite port of registration for yachts based in EU countries.

Portugal has about 45 double tax treaties in effect and another 5 concluded, but not yet effective. Currently effective tax treaties include those with Canada, France, Germany, Italy, the Netherlands, Spain, Switzerland, the United Kingdom and the United States.

The application of the Canada/Portugal tax treaty to Madeira corporations is limited primarily to corporations that carry on an "active business" in Madeira. The US treaty (Article 17(6)) specifically excludes Madeira companies from the benefits of the treaty. The other treaties listed above (and most of Portugal's other treaties) do not appear to exclude Madeira companies from their benefits.

Madeira has set up a 138-hectare Industrial Free Trade Zone, near the airport, where manufacturing and assembly operations are carried on, generally free of all direct and indirect taxation until 31 December 2011.

A company manufacturing a product that can be air freighted to its destination may find it worthwhile to investigate moving some manufacturing facilities to the Madeira Free Trade Zone. A substantial saving in corporate taxation may be possible (at least for the next five years). The local workforce has a reputation for manual dexterity. It should be possible to find good business reasons for the transfer of manufacturing, assembly or service operations to Madeira, avoiding the artificiality which so upsets many tax authorities and can lead to litigation.

Apart from the manufacturing possibilities, there are many other ways of taking advantage of the tax benefits that Madeira can offer. Two ideas are discussed below, one involving EU import duties and the other solving a potential VAT problem. Either one could be of interest to groups operating outside the EU.

The first is to consider relocating final assembly operations to Madeira. Madeira is part of Portugal, and Portugal is a member of the EU. There are no import duties between EU member countries when value has been added to the product by a Madeira corporation.

For example, an Italian parent company had a manufacturing subsidiary in India producing electronic equipment which was shipped from India to various EU countries. Import duty had to be paid on the electronic equipment in each EU country. The Italian parent wanted to eliminate the import duties. To do so, they changed the manufacturing procedure, so that their Indian subsidiary no longer provided final assembly. Instead, components were shipped from India to the Madeira Free Trade Zone, where there are no Portuguese duties on imports. Final assembly was carried out in the Free Trade Zone by a Madeira subsidiary of the Italian parent. The assembled electronic equipment was then air freighted to various EU countries free of duty.

The Madeira subsidiary earned an arm's length profit on its final assembly operations, free of tax. The Indian subsidiary thus reduced its taxable income, which was subject to the (high) rate of Indian corporation tax. The result was a substantial saving of EU import duties and Indian corporate tax, which more than offset the additional air freight and related costs.

This example illustrates a possible solution to import duty problems for a non-EU manufacturer shipping into the EU. However, because shipping costs from Madeira are quite high, the product may need to be high-value for this to be cost-effective.

What are the possible problems when considering manufacturing or assembly operations in Madeira?

- The Madeira workforce is Portuguese speaking; most have limited knowledge of English
- The availability of local labour with the required skills must be researched
- The company's official books must be prepared according to Portuguese law (however, local management companies are able to handle this), and
- The low tax regime expires in 2011. It is uncertain whether it will be modified or renewed for a further term.

The second tax planning possibility relates to e-commerce. In year 2000, the EU passed a Directive and Regulations requiring that, from 1 July 2003, all companies based outside the EU and doing business directly with the final customer in the EU must bill VAT at the rate applicable in the EU country to which the delivery was made. An example of such business is the sale of products downloadable from the Internet, such as music or computer games.

It is difficult for a non-EU based company to bill VAT to twenty-five different EU countries, each with its own VAT rate. The seller has to calculate VAT for each country, collect it from the customer and remit the VAT to the country concerned.

It is understood that there has been a significant degree of non-compliance with this requirement, perhaps because the selling companies believe that there is little chance of being assessed (or of having collection enforced) for failure to collect and remit the VAT. Together with interest and penalties, accumulating over many years, a huge contingent liability can build up. Ignoring the EU Directive may be an acceptable risk in the short term, but there are ways now available to catch international VAT evaders. For example, since most customer payments are made by credit card, EU countries could require credit card companies to provide information to their tax authorities sufficient for them to get the information they need. This approach is already being followed by the U.S. and the U.K. tax authorities, among others, to search out income tax evaders.

There is a solution.

A subsidiary of the selling non-EU company, incorporated in Madeira, could be used as an invoicing company. Madeira has become a hub for fibre optic cable, with high bandwidth availability. VAT at 15% would be added to all billings to customers in the EU, unless the customer is registered for VAT in their own country. This would be the least expensive way of complying with the EU Directive and would eliminate the contingent VAT liability. Several management companies based in Madeira have the skills and facilities to provide this service.

There will be no significant income tax benefit, as only a tiny (arm's length) mark-up to cover administrative activities is likely to be acceptable to foreign tax authorities concerned with transfer pricing - but that is not the objective.

EU countries, perhaps deliberately, are taking no steps at present to enforce the collection of VAT on sales made by non-EU companies through Internet downloads. Maybe they are waiting until substantial unpaid balances have been built up. When they are ready, they may look for tax collection support from non-EU countries, such as Canada and the United States. Some may consider enacting legislation similar to U.S. legislation, which gives the U.S. the right to retain funds from balances held by correspondent banks.

It is clear that the low-tax jurisdiction of Madeira provides numerous opportunities for tax planning. The suggestions above are intended to engage the interest of creative tax professionals.

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