Francisco de Sousa da Câmara* and Bruno Santiago**

Common Consolidated Corporate Tax Base

1. Application of Non-Arm's Length Methods in Portugal

The arm's length principle has a consolidated presence in the Portuguese tax system. It was first introduced in Art. 51.º-A of the Industrial Tax Code (*Código da Contribuição Industrial*) in 1964 as a general principle and was set out in very broad terms. Following the introduction of the Corporate Income Tax Code (*Código do Imposto sobre o Rendimento das Pessoas Colectivas*, CIRC) in 1989, which introduced a modern system of company taxation in line with the OECD, the arm's length principle was upheld but was outlined in similarly broad terms as before. However, the absence of detailed rules on transfer pricing before 2001 did not impede the tax authorities from making corrections to taxpayers' declared profits using the arm's length principle as a basis.[1] One of the main criticisms at that time was that the principle was too broad and there was no guidance on how to apply it. Unconstitutionality was even cited by taxpayers before the Constitutional Court due to the lack of detailed rules on the matter, but without success.[2]

It was only in 2001 when there was a major tax reform that the parliament for the first time introduced detailed rules on transfer pricing in line with the OECD Guidelines.[3]

The Portuguese transfer pricing regime in force uses the arm's length principle as the standard, although it can be said that in some situations the law allows for the application of formulas to determine the taxable profit attributable to each party in a transaction between related entities.[4] This is the case regarding the applicability of the profit split method, which is allowed if the comparable uncontrolled price method, the resale price method or the cost-plus method cannot be applied or when the said methods are not able to obtain the most reliable measure of the terms and conditions that would be agreed between unrelated entities.[5]

This profit split method is applied by determining the global profit earned by the associated enterprises in the controlled transactions and then allocating the profit between them; the criterion is the relative value of the contribution of each of them in carrying out the transactions, bearing in mind the functions performed, assets employed and risks assumed by each. Reference may be made to reliable external data showing how independent entities that perform comparable functions, employ the same kind of assets and assume the same risks would have measured their contributions. As an alternative, this method may be applied in another way that approximates a sort of formulary apportionment, namely by allocating the global profit from the transactions in two stages. First, each intervening entity is assigned a portion of the global profit that reflects an appropriate level of routine profit for the transaction, based on comparative data obtained from analysis of transactions between independent entities carrying out similar transactions, bearing in mind the functions performed, assets employed and risks assumed. This can be classified as the routine profit element. For this part of the analysis, any of the other methods may be applied. Second, the remaining, or residual, profit or loss is allocated to each entity in proportion to the value of its contribution, bearing in mind the functions performed, assets employed and risks assumed. For this purpose, external information will be obtained to provide indications as to how independent parties share profits or losses under similar circumstances; the underlying transfer price will be calculated on the basis of the profits thus assigned.[6]

In the authors' opinion, the use of the profit split method in the last stage described above already introduces a method of apportionment which, although intended to comply with the standard of the arm's length principle, departs from the principle's underlying logic.

In a way, considering that the profit split method may depart from arm's length methods and that it is akin to an apportionment method, as Portugal admits the possibility to conclude unilateral, bilateral or even multilateral advance pricing agreements (APAs), some sort of profit apportionment is already, at least in theory, available in Portugal. However, to the best of the authors' knowledge, there is no bilateral or multilateral APA signed by Portugal using the alternative profit split method.

Moreover, the transfer pricing regime in force also allows related parties when using a cost-sharing agreement, to

* **Lawyer and partner of Morais Leitão, Galvão Teles, Soares da Silva e Associados, Lisbon. The author can be contacted at fscamara@mlgts.pt.**

** **Lawyer, Morais Leitão, Galvão Teles, Soares da Silva e Associados, Lisbon. The author can be contacted at brunosantiago@mlgts.pt.**

1. A compilation of cases may be found in Glória Teixeira, Duarte Barros (coord.), *Preços de Trnasferência e o Caso Português*, (Vida Económica, 2004).
2. The constitutionality of the norm was discussed several times before the Supreme Administrative Court. For a comment to the decision of the Constitutional Court referred to in the text here, see Francisco de Sousa da Câmara and Bruno Santiago, "Preços de Transferência e Princípio da Legalidade Fiscal, Anotação ao Acórdão do Tribunal Constitucional n.º 252/05", *Jurisprudência Constitucional* 11 (July-September 2006), at 19 ff.
3. Currently, Art. 63 of the corporate income tax code, Ordinance 1446-C/2001 of 21 December 2001 and, more recently, Ordinance 620-A/2008 of 16 July 2008 on APAs.
4. A translation of the Portuguese transfer pricing regime is available in English. See Leendert Verschoor, "New Implementation Measures Regarding Transfer Pricing Rules", 9 *International Transfer Pricing Journal* 4 (2002), at 107.
5. Art. 63(3)(a) CIRC.
6. Art. 12(3) Ordinance 1446-C/2001.

apply a formula to allocate the costs between the participating entities. According to Art. 11(3) of Portaria 1446-C/2001:

> the proportionate share of the overall contributions for which each participant is liable should be consistent with the participant's proportionate share of the overall benefits to be received under the arrangement, as assessed from estimates of additional income to accrue in future or expected cost savings. If a direct or individual assessment of these considerations is not possible, an appropriate allocation key can be applied, taking into account the nature of the activity and an indicator that adequately reflects the expected benefits, including turnover, labour costs, value added or capital invested.[7]

In the case of cost-sharing agreements, the possibility to use an allocation key that takes into consideration income, costs and capital is also recognized.

Furthermore, with regard to intra-group services, when it is not possible to follow a direct method to determine the price of each service, namely when it is difficult to individualize or quantify the costs associated with the rendering of such service, an indirect method is allowed.[8] This indirect method will involve the allocation of the overall costs of services among the various group entities on the basis of an appropriate allocation key. This should reflect the proportionate share of the value of the services imputable to each recipient and make it possible to calculate a cost comparable to the cost that independent entities would be prepared to pay in a comparable non-controlled transaction.

The allocation key referred to in the preceding paragraph should be constructed on the basis of indicators that suitably reflect the nature and use of the services provided. Specifically, sales volume, gross margin, personnel expense and units produced or sold can be admissible.

Moreover, in determining the taxable profit of permanent establishments of non-resident entities, the law establishes that general expenses of administration attributable to the permanent establishment, according to accepted criteria for allocation and within limits deemed reasonable by the tax authorities, may be deducted in determining taxable profit, and states that the allocation must be justified in the tax return and consistently followed from one year to the next. Notwithstanding the previous paragraph, where it is not possible to make an allocation based on use by the permanent establishment of goods and services that constitute general expenses, the following are admissible as criteria for allocation: turnover, direct costs and tangible property.[9]

Notwithstanding the oblique introduction of some forms of allocation methods into the Portuguese transfer pricing regime, to determine the share of the overall profits of the group to be attributed to each company, it should be affirmed that with regard to corporate income tax, the arm's length principle is the standard used in the taxation of multinational enterprises. Considering that, despite the references made above, there is no tradition in the use of formulary apportionment methods in the taxation of multinationals, the authors think that the introduction of these methods would be viewed with great suspicion by the Portuguese tax authorities mainly because of their fear of losing tax revenue.

However, besides the manifestations of some sort of allocation key to determine the profit to be attributed to each company in an integrated group, some forms of formulary apportionment are also known at the state budget level. The use of a formula to apportion tax revenue between the different entities (state vs the municipalities) that are legally entitled to such revenue occurs under Portuguese law in some circumstances. These are mainly related to municipal taxes, i.e. taxes the revenue from which is to be attributed to the municipalities.

The first example is the so-called *derrama*. This is a tax collected together with corporate income tax that is due annually on the taxable profit subject to and not exempted from corporate income tax which corresponds to the portion of income generated in the geographic area of the municipality by resident corporate entities that perform commercial, industrial or agricultural activities, as well as non-residents with a permanent establishment in Portuguese territory. The tax rate is fixed annually by each municipality and can vary between 0% and 1.5%. This tax is administered and collected by the tax authorities, which then transfer the revenue generated to the municipalities.

If a corporate entity has establishments or representations in more than one municipality, an apportionment formula is needed to allocate the income between the municipalities. The formula chosen by the parliament is based solely on payroll: if the corporate entity has establishments in more than one municipality and a taxable profit of more than EUR 50,000, the taxable profit allocated to each municipality is determined by the ratio between the payroll corresponding to the establishment that the taxpayer has in each municipality and the total annual payroll (in Portuguese territory).

Moreover, in the case of the *derrama* there is a special rule for taxpayers the annual turnover of which derives more than 50% from the exploration of natural resources. In these cases, the municipalities affected may, exceptionally, propose a specific formula which, after hearing the taxpayer and the other municipalities affected, is sanctioned by an ordinance made by the Ministry of Finance and the ministry that oversees the municipalities (currently the Ministry of Parliamentary Affairs).[10]

The introduction of a formulary apportionment might also be called for in relation to the tax on the holding of immovable property (*imposto municipal sobre imóveis*, IMI), a tax charged annually on the owners of immovable

7. Authors' translation.
8. Art. 12(6)(7) Portaria 1446-C/2001.
9. According to Manuela Duro Teixeira, *A Determinação do Lucro Tributável dos Estabelecimentos Estáveis de Não Residentes* (Almedina, Coimbra, 2007), at 70, this allocation regime should be considered revoked since the introduction in 2001 of detailed rules on transfer pricing.
10. For further developments, see Saldanha Sanches, "A derrama, os recursos naturais e o problema da distribuição de receitas entre os municípios", *Fiscalidade* 38 (2009), at 131 ff.

property, and the municipal tax on the transfer of immovable property (*imposto municipal sobre transmissões onerosas de imóveis*, IMT). With regard to these two taxes, a formula could be justified in relation to property situated in more than one municipality. However, in this case, the law follows an "all or nothing" criterion, thereby avoiding apportionment problems. In these situations, in the case of urban property, the property is deemed to pertain to the municipality where the main entrance is located and, in the case of rural property, there is a distinction between fenced and non-fenced properties. If the property is fenced, it is deemed to pertain to the municipality where the main entrance and path are located. If it is non-fenced, it is deemed to pertain to the municipality where the major part of the property is situated (no rule is established for situations where the parts of the property are equally divided between two or more municipalities).

Finally, the annual revenue generated from the personal income tax is also apportioned, to a certain extent, to the municipalities. Although the revenue from this tax traditionally belongs to the state, since 2007 each year the municipalities may receive a participation of up to 5% of the personal income tax collected from individuals resident in the area of the respective municipality. Each municipality must inform the tax authorities of the percentage requested. If the percentage requested by the municipality is less than the maximum allowed (5%), the result of that difference is multiplied by the personal income tax due and that result will be considered a deduction from the personal income tax due.

With regard to tax treaties, the majority of Portuguese tax treaties include a clause along the lines of Art. 7(4) of the 2008 OECD Model Convention. However, in some treaties that clause does not even exist (e.g. the treaties with Canada, France, Mozambique, Spain, the United Kingdom and the United States). Particularly in the case of the treaty with the United States, that clause does not exist, but the protocol states:

> it is understood that each Contracting State may apply its own domestic law, whether based on tracing or allocation, for attributing research and development expenses, interest, and other similar expenses to a permanent establishment situated in its territory, provided that such rules are consistent with the provisions of article 7.

As Portugal does not traditionally determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parties, the introduction of common consolidated corporate tax (CCCTB) may be regarded as clashing with existing tax treaties.[11]

2. Administrative Expenses

Regarding administrative expenses, the authors consider that the adoption of the CCCTB system in Portugal may reduce and simplify to a certain extent the administrative expenses incurred by businesses, which may benefit from this regime in comparison with the present situation. This reduction and simplification will depend, of course, on the forms and ancillary obligations that the companies will be obliged to comply with.[12] In any case, a reduction of transfer pricing documentation as well as the costs of complying with different domestic tax laws may be foreseeable in the long run.

However, adjustments still must be made internally with regard to taxes that depend upon the corporate income tax, as in the case of the *derrama* described above. Furthermore, in comparison with the present situation in Portugal in which the companies composing a tax group must deliver their annual returns separately and the head of the group must submit both an individual return and the return of the group (if, as it seems, under the CCCTB the presentation of individual returns can be avoided), there may be less administrative costs, even taking into consideration that the consolidated return may be more burdensome to complete than the one presently applicable in Portugal.[13] There are a number of other ancillary obligations that companies in Portugal must comply with, namely the completion and submission of a form known as "IES", where material and extensive information must be submitted to the tax authorities. In order to determine whether administrative expenses will be reduced or simplified, it is necessary to ascertain to what extent these obligations will cease, be maintained or be replaced by even more burdensome information requirements. This issue is not yet fully addressed in the Draft Directive.

With regard to the tax authorities, it is foreseeable that their administrative expenses will increase. This will certainly be the case in the short term as, among other expenses, training must be given to the relevant tax officials and new electronic platforms must be planned and developed. In the medium to long term it is difficult to predict, but the introduction of the CCCTB most likely will not lead to a significant reduction in the administrative expenses of the tax authorities. Among other possible reasons, the fact that this new system will be optional means that it will coexist with the existing system and therefore it will probably lead to an increase in costs. Moreover, the tax authorities will be compelled to collaborate in a more integrated manner among themselves which, of course, will also increase administrative costs.

3. CCCTB vis-à-vis the Common Corporate Tax Base

Among scholars as well as tax authorities, there is a common understanding that from a tax policy perspective it is more desirable to have a broad tax base (and eventually lower rates) than a narrow tax base. As the authors admit that the introduction of a common corpo-

11. For further developments on the compatibility of the CCCTB with existing tax treaties, see Baker and Mitroyanni, "The CCCTB Rules and Tax Treaties", *Common Consolidated Corporate Tax Base*, Michael Lang et al. (Eds.), Series on International Tax Law, Vol. 53, (Vienna: Linde, 2008).
12. For further developments on this discussion, see CCCTB WG, *Points of discussion for 'Administrative and Legal Framework'*, Brussels, 19 May 2006, (CCCTB\WP\036\doc\en), document available on the EU Commission webpage dedicated to the CCCTB.
13. In Portugal there is no true consolidation regime, but only a system of profit/loss offsetting between members of the group.

rate tax base (CCTB) at the EU level would tend to follow a broad base,[14] they believe it would be easier to obtain agreement in Portugal to the introduction of a CCTB than a CCCTB. Besides, another argument in favour of a CCTB at a first stage, as opposed to the proposed CCCTB, is that cross-border consolidation will almost inevitably lead to loss of tax revenue, which is critical in the present Portuguese financial situation.[15]

4. Experience with Regard to the Application of Formulary Apportionment Systems Operated by Other States

To the best of the authors' knowledge, neither the tax authorities nor the business community in Portugal have acquired experience with regard to the application of formulary apportionment systems operated by other countries.[16]

5. The Formulary Apportionment Proposed in the Draft Directive

The introduction of formulary apportionment mechanisms makes sense in integrated economies in order to boost cross-border activity and remove tax obstacles that necessarily affect the desired neutrality in taxation. The three-factor formula is namely well-known in the United States, and therefore the European Union may learn about its problems and difficulties.[17] The authors consider that generally the solutions reached in the Draft Directive concerning the relative weight of each factor as well as the way each factor, is being considered, are fair and reasonable, taking into account the technical and policy problems that will always exist.

The non-inclusion of intangibles and financial assets in the apportionment formula due to their mobile nature and risk of circumventing the system is probably the most reasonable solution at the present stage. However, this option should be carefully evaluated down the road, namely to understand if the non-inclusion of financial instruments and intangibles may or may not lead to more serious direct or indirect distortions than their inclusion as assets. In the authors' opinion, notwithstanding the need to develop further studies and discussions on the topic, it is important to bring these assets to the formula in the medium term. These are very important assets that play a huge role in modern societies and are able to generate large profits that will not be allocated to the state where they belong. Apparently contradictory is that most likely the countries in which those assets are located will be the first to defend their non-inclusion in the formula. In fact, the presence of the financial and knowledge industries in one country allows and contributes to the emergence of new ancillary industries which, in turn, bolsters the economy and tax revenues.

At first glance it could appear that the exclusion of these assets would not lead to their artificial allocation to jurisdictions with lower tax rates, as their weight is not taken into consideration.[18] However, as in certain cases the proceeds of the sale of intangibles and financial assets may be considered in the sales factor, it may be useful to locate them in a jurisdiction with a lower tax rate.

The safeguard clause is clearly exceptional and is to be used in very select cases. It is not easy to foresee in which cases it could be applicable, but perhaps the mining industry in some situations (not included in the oil and gas exploration treated in Art. 100 of the Draft Directive) could be an example, namely because of the erosion of natural resources that such activity may imply and the possible result that the state that suffers most from the exploitation does not receive a fair share in comparison with other states where the group is situated.

6. Rules for Depreciation Purposes and Valuation on the Occasion of Opting In or Opting Out of the System

The authors agree with the general rule on the recognition and valuation of assets and liabilities established in Art. 44 of the Draft Directive on the occasion of opting in into the system. The authors consider that the transition to the CCCTB should be as neutral as possible in order to comply with the ability-to-pay principle and avoid situations of double taxation or double non-taxation. The rules adopted for opting in and opting out seem to be fairly reasonable and straightforward to achieve those results. However, it is important that rules be introduced in the domestic systems of the Member States to avoid considering that upon opting in for the CCCTB, there is a taxable disposal at market value. However, anti-abuse provisions should be drafted to avoid a taxpayer moving to the CCCTB just to sell an asset and pay less corporate

14. The generality of the studies produced on this issue indicate that the introduction of a CCTB could lead on average and for most EU-based companies to tax bases broader than the current ones. On the contrary, even with a broader tax base, the introduction of the CCCTB with the possibility of compensating losses in cross-border situations would lead to a shrinking of the tax bases of the companies operating cross border. See Commission Staff Working Document, "Impact Assessment Accompanying document to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)", Brussels, 16 March 2011, SEC(2011) 315 final, at 25 ff, available on the European Commission website.
15. Of the overall corporate income tax revenue, the biggest share comes from a dozen of the largest Portuguese economic groups that normally are also present in other EU Member States.
16. Perhaps a few groups operating in different states of the United States may have some experience in this regard.
17. For a discussion of these difficulties, see CCCTB WG, "An overview of the main issues emerged during the discussion on the mechanisms for sharing the CCCTB", Brussels, 27 February 2007, (CCCTB\WP\052\doc\en); "Report and overview of the main issues that emerged during the discussion on the sharing mechanism SG6 second meeting – 11 June 2007", Brussels, 20 August 2007 (CCCTB\WP\056\doc\en); "CCTB: possible elements of the sharing mechanism", Brussels, 13 November 2007 (CCCTB\WP\060\doc\en), documents available on the EU Commission webpage dedicated to the CCCTB, at 6 ff. For further developments, see Bruno Vinga Santiago, "O Futuro da Tributação Directa dos Grupos de Sociedades na União Europeia, *Fiscalidade* 16 (Lisbon, ISG, 2003) and Stefan Mayer, *Formulary Apportionment for the Internal Market*, Vol. 17, Doctoral Series (Amsterdam: IBFD, 2009).
18. For a similar view alerting, however, to the risk of an outflow of such activities from the European Union, see Pedro Saavedra and Juan Salvador Pastoriza, "EU Common Consolidated Tax Base Proposal", *Journal of International Taxation* (August 2011), at 39.

income tax than it would have paid if it had not opted for the CCCTB.[19]

7. Self-Generated Intangibles upon Leaving the Group

Currently under Portuguese law, all research, marketing and advertising expenses are treated as a cost in the year they were incurred, provided that those expenses were incurred for the purposes of the taxpayer's business activity (in the words of the law, "[c]osts or losses that are demonstrably indispensable to the generating of income and gains subject to tax or to the maintenance of the productive source are deductible"). Development expenses may be deducted from the tax base in the year they were incurred, or the taxpayer may opt for depreciation over three years. Under Art. 32(2) of the CIRC, development expenses are those incurred by a company through the exploitation of results from research or other scientific or technical knowledge for the discovery or substantial improvement of raw materials, products, services or manufacturing processes.

Art. 68 of the draft Directive establishes that when a taxpayer leaves the group, the research, development, marketing and advertising expenses related to self-generated intangible assets from the previous five years will be recaptured and added to the consolidated tax base of the remaining group members. On the other hand, those costs will be attributed to the departing taxpayer and treated in accordance with the respective national corporate tax law which becomes applicable to the departing taxpayer.

In the authors' opinion, to achieve the desired neutrality, a new rule should be introduced in domestic corporate tax law to allow the departing taxpayer to deduct such costs in the year following the year it leaves the group or, in the case of development expenses, to permit the taxpayer to depreciate those expenses over three years. In the absence of such rule, the deduction of such costs may be considered to conflict with the accrual rule, as those expenses relate to previous tax years.

8. Business Restructuring in CCCTB and Domestic Corporate Tax Law

With regard to business restructuring, domestic law establishes a neutral regime along the lines of Directive 2009/133/EC on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States. Accordingly, among other conditions, tax neutrality may be granted, provided that a permanent establishment is left in Portuguese territory and the assets remain attached to such permanent establishment.

Moreover, the CIRC establishes an exit tax if a company transfers its head office or place of effective management to another state and the assets do not remain attributed to a permanent establishment of such company located in Portugal. To determine the taxable profit for the accounting period of cessation of activity of an entity with its place of effective management based in Portuguese territory, including a European Company and a European Cooperative Company, due to its head office and place of effective management no longer being situated in Portugal, the positive or negative differences between the market value and the book value of the assets relevant for tax purposes at the date of termination must be included in taxable income.[20]

The rules of Chap. XI of the Draft Directive will allow that in business restructurings some assets may be transferred to another Member State without triggering any taxation in the exit state (provided that those assets do not constitute "substantially all the assets of the taxpayer"). This rule differs from the Portuguese rule and creates a more favourable environment for business restructurings with regard to companies that opt for the CCCTB. This different treatment, if not considered discriminatory, should be extended to companies that will not opt for the CCCTB as, otherwise, it can encourage companies to opt for the CCCTB merely for tax planning purposes related to planned business restructurings, thereby undermining the reasons behind the introduction of this system.

9. Future Outlook

It is impossible to predict if the CCCTB will ever see the light of the day in the European Union. Even if it is possible to introduce it, either by the universal consensus of all Member States or by the enhanced cooperation mechanism in some Member States, it will coexist with and not replace the arm's length principle.

19. For further developments on tax planning opportunities related to hidden reserves, see Daniela Hohenwarter, "Moving In and Out of a Group", *Common Consolidated Corporate Tax Base*, Michael Lang et al. (Eds.), Series on International Tax Law, Vol. 53, (Vienna: Linde, 2008), at 184 ff.

20. The conformity of this regime with the freedom of establishment is being challenged by the Commission in the European Court of Justice in Case C-38/10. Briefly, the European Commission considers that the Portuguese legislation goes beyond what is necessary in order to attain the objectives pursued, that is to say, to ensure the effectiveness of the tax system. Consequently, the Commission considers that the Portuguese legislation must apply the same rule whether the registered office, effective centre of management or assets are transferred out of Portuguese territory or whether they remain there; the tax must be charged only after the increase in the value of the assets has been realized.