PRACTITIONERS' CORNER

Portugal — Software Taxation, Tax Treaties, and the OECD Model

by Francisco de Sousa da Câmara and Gustavo Lopes Courinha

Francisco de Sousa da Câmara is a partner with Morais Leitão, Galvão Teles, Soares da Silva & Associados in Lisbon, and Gustavo Lopes Courinha is a senior associate with RPBA & Associados in Lisbon.

On February 2, 2011, the Administrative Supreme Court (the highest jurisdiction on tax matters) adopted a decision with significant repercussions not only for the taxation of software but also for all payments made to nonresidents. The Court in its analysis distilled various elements in assessing the applicability of the rules of the treaty (in this case the 1969 Belgium-Portugal treaty), its interaction with the OECD model (its different versions), as well as the value of the Portuguese reservations and observations.

The Court was requested to review a decision issued by the Tax Court of Leiria (court of first instance), which upheld the tax authorities' tax assessment; the court of first instance agreed that the periodic (yearly) payments made by a Portuguese corporation for the updating of a software license granted for internal use only to a Belgium resident company should be characterized as remunerating know-how and be subject to corporate withholding tax as royalties. The dispute between the parties dealt with two issues. First, it would be relevant to determine whether such income can be taxed under domestic tax provisions or not; second, assuming the existence of such right of taxation by the state of source (Portugal), one would need to verify whether the Belgium-Portugal income tax treaty had prevented Portugal from taxing such income. In the course of their discussions and analyses, the parties invoked the history of tax treaties and the evolution from the OECD model treaty.

The Parties' Positions

The plaintiff was a Portuguese corporation that qualified the payment made to the Belgium company as a mere service fee (software license fee) not subject to withholding tax, so it paid the fee gross. The tax authorities did not agree with that view and made a tax assessment against the Portuguese corporation because it was held responsible for the tax due by a nonresident without a permanent establishment in Portugal. As noted above, the Tax Court of Leiria upheld the tax authorities' views and considered that the tax assessment was neither illegal nor jeopardized by the Belgium-Portugal treaty.

In its appeal to the Supreme Court, the Portuguese corporation contended that:

- the Tax Court of Leiria did not explain and justify which and what type of know-how was deemed to have been rendered under the license agreement;
- the payments for the use of the software license made in 1995, 1996, and 1997 remunerated the possibility to use such software program in the activity of the plaintiff, namely enabling the latter in designing metallic structures;
- the Belgium company did not grant specific know-how but merely allowed the Portuguese corporation to apply and use a computer program for internal purposes;

- intellectual property income obtained by nonresidents in Portugal is subject to tax, but considering that software income is not covered by such concept in accordance with Portuguese law, the proceeds paid for the license agreement are not subject to tax under domestic tax law;
- software is not considered or protected as a literary, artistic, or scientific work under Portuguese law;
- the term and definition of royalties in the 1969 Belgium-Portugal tax treaty followed the 1963 OECD model and did not cover the remuneration of software;
- in 1992 Portugal introduced a reserve in the OECD model to tax as royalties all software income that is not derived from a total transfer of the rights attached to the software (paragraph 43 of the commentary to article 12), but this reserve was only used in the 1999 Portugal-Singapore treaty; and
- for the purposes of this case the reserve introduced in 1992 on the OECD model is absolutely irrelevant, and does not bind the parties that entered into the Belgium-Portugal treaty or the taxpayers benefiting from the treaty.

The tax authority did not present any written allegations to the Court, but the public prosecutor recommended upholding the decision adopted by the court of first instance. According to the Belgium-Portugal treaty, Portugal can tax royalties obtained by a Belgian resident granting know-how to a Portuguese entity. However, instead of justifying Portuguese taxation under the specific transfer of know-how as the court of first instance argued, the public prosecutor referred to a previous decision adopted by the Court on March 18, 2008, where the value attributed to the 1992 OECD model reserve, introduced by Portugal regarding the possibility to tax software income, was pivotal in deciding that income paid abroad for the partial transfer of the rights attached to the software should be considered royalties for treaty purposes and taxed at source in Portugal.

Domestic Law and the Treaty

The Court held that the Belgium-Portugal treaty did not generate a tax claim that does not otherwise exist under Portuguese domestic law, but could restrict or prevent such power. The treaty may relieve from tax something that might otherwise be subject to tax.

Curiously, the Court avoided deciding the case based on the domestic rules, namely on whether such income was subject to tax under domestic law. The Court confirmed that:

- Portuguese law does not define royalties;
- intellectual property income is subject to tax, provided it is income from a literary, artistic, or scientific work protected under Portuguese law; and
- in 1969, when the Belgium-Portugal treaty was signed, software was not protected as a literary work.

Moreover, the Court stated that, according to the Portuguese legal system, the treaties entered into by Portugal prevail over the internal rules (with the exception of constitutional rules) on a hierarchical basis, as set out by article 8 of the constitution and articles 26 and 27 of the Vienna Convention on the Law of Treaties.

The Decision

Summary

This case allowed the Court to address several important topics, some of them for the very first time. The Court also addressed the issues comprehensively in nearly 30 pages of discussion and references to several papers and authors.

The Court considered that it would be inappropriate to decide the case by making a characterization of the license agreement as an eventual transfer of know-how, preferring to analyze whether the payment for the software license should be considered a royalty.

Then, considering that such software income only remunerated the partial transfer of software for personal use, the Court considered that the Belgium-Portugal treaty prevented Portugal from taxing the income paid to the Belgian entity insofar as such income could not be qualified as royalties for the purposes of article 12 of the treaty. The reserve, introduced by Portugal in 1992 on the OECD model to tax software, was considered irrelevant.

For the Court, it would be necessary that the other contracting parties should also have adopted the same observation. (See, for instance, paragraph 28 of the commentary to article 12; Mexico and Spain adopt the same observation.) Otherwise they should not be considered bound to the interpretation adopted by Portugal.

Even though the taxation of software was not a clear subject under Portuguese domestic law, the Court decided to tackle the international level of the discussion — to determine whether the conventional regulation of software taxation would prevent its Portuguese taxation.

In fact, the Court preferred to rule that even if domestic law already allowed software income to be qualified as a ''literary, artistic, or scientific work'' at the time the payments were made (1995, 1996, and 1997), following the analogous protection granted by Decree-Law 252/94 (which is ''very uncertain,'' as bluntly stated by the Court) the 1969 treaty (which did not cover the software income in the term ''royalties'') prevents taxation from occurring in Portugal.

To deal with the tax administration's allegation that income derived from software is, as a rule, tantamount to royalties for treaty purposes, the Court had to cope with the legal value of the Portuguese reserve introduced in 1992 to tax all software income.

Surprisingly, none of the parties mentioned that the Portuguese reserve regarding software (paragraph 43 of the commentary on article 12) was deleted in the 2008 OECD model, and they did not highlight that Portugal decided to introduce an observation (section 28) in the same version of the OECD model.

According to this observation (section 28):

> Mexico, Spain and Portugal do not adhere to the interpretation in paragraphs 14, 14.4, 15, 16 and 17.1 to 17.4. Mexico, Spain and Portugal hold the view that payments relating to software fall within the scope of the Article where less than the full rights to software are transferred either if the payments are in consideration for the right to use a copyright on software for commercial exploitation (except payments for the right to distribute standardized software copies, not comprising the right neither to customize nor to reproduce them) or if they relate to software acquired for the business use of the purchaser, when, in this last case, the software is not absolutely standardized but somehow adapted to the purchaser.

The Portuguese tax administration and the court of first instance believed that since neither Belgium nor any other country disputed the Portuguese reservation, then one should conclude that the Portuguese right to tax the software income as royalties was not limited.

The Court considered that even if the reservation should be understood as an observation, the Portuguese interpretation cannot be immediately applied to every single treaty concluded by Portugal, regardless of when they entered into force.

In this respect the Court considered that in relation to treaties already signed, such observation could only be invoked in connection with other contracting states that adopted and agreed with a similar observation. The way the Court countered those positions is worth studying, because it denies the (un-) official position according to which the terms of the conventional distribution of taxing rights can be changed without the renegotiation of a particular treaty, by mere modification of the observations to the OECD model.

Therefore the Court supported the judicial appeal and considered the tax assessment illegal and void.

Brief Overview of the OECD Model

The importance of the OECD model and its commentary, including the observations and reservations in abstract, was discussed in detail and put in context with the applicable bilateral treaty (the 1969 Belgium-Portugal treaty) and the concrete reservations and observations presented by Portugal since 1969. The main aspects stressed by the Court are provided below.

First, the Court argued, the OECD model cannot be considered anything but a draft, although a very useful and important one, both because it is adopted on a worldwide basis as a standard for bilateral treaties and because its commentaries are a useful interpretation instrument.

The commentaries to the OECD model are, accordingly, considered valuable doctrine, useful in finding the sense for OECD model rules, but without binding effects on both courts and tax administrations. And this is true, the Court stated, for both OECD member and nonmember states.

Second, the Court supported the view that reservations on the OECD model are not proper reservations. Instead, they must, at all times, be adopted in every single treaty to become valid; otherwise, the Court stated, they stand for no more than a mere statement of intentions on the part of the member state.

This point is critical for the Court. According to its reasoning, either the other state entering a treaty with Portugal agrees on the definition of royalties, or such a state cannot be bound to the interpretation set out on such ''reservation,'' thus preventing its legitimacy. In the Portuguese case, this was especially important since, between 1992 and 2008 (the period during which Portugal adopted section 43 of article 12(2) of the OECD model), only two out of more than 30 countries entering into a treaty with Portugal accepted such an unusual position regarding software taxation on the terms of the treaties.

That the remaining countries declined such a proposal in bilateral negotiations that precede the signature of a treaty could not, the Court said, be ignored. In such circumstances, the reservations inserted in the OECD model are to be considered irrelevant and inapplicable.

Third, the Court dealt with the 2008 Portuguese observation on article 12 of the model, relating to the meaning of the term ''royalties,'' inserted in section 28.

The tax administration believed that it should be irrelevant from then on (that is, since 2008) to discuss whether reservations to the OECD model were adopted on a case-by-case basis because the Portuguese observation was allegedly to be considered applicable to every treaty entered into by Portugal.

The Court did not agree with this view, however. On the contrary, the judges affirmed that the observations are deprived of effects in relation to the countries that will not adhere to them. Again, this is relevant as far as Portugal is concerned because it significantly reduces the scope of application of the treaty, since only Spain and Mexico have adopted a similar position concerning the taxation of software as royalties.

The last issue addressed by the Court had to do with whether the Portuguese ''reservation'' of section 43 — adopted since 1992 — could be materially considered an ''observation'' and, thus, applicable retroactively.

That question went without a clear answer, but the Court made a strong point in considering that such interpretations could not be valid as far as pre-1992 treaties were concerned, thus denying the possibility of applying latter observations to treaties already in force.

This was so, the Court argued, because the taxation of software was not even an issue before 1992. The taxation of software was not addressed autonomously in the OECD model before 1992, and the negotiators could not have intended to consider such income as royalties, let alone have had that intention in accordance with commentaries and observations to the OECD model that did not even exist.

Furthermore, the Court concluded, to admit such an interpretation would be equivalent to a unilateral change of the balance of the treaties and the denial of the reciprocity of concessions on which they all are based.

Conclusion

In spite of not taking the opportunity to clarify whether software income obtained by nonresidents is subject to tax in accordance with domestic law, the Court adopted a landmark decision.

First, the court confirmed that a bilateral treaty prevails above domestic law. Second, the Court questioned whether the Belgium-Portugal treaty prevented the application of domestic taxation, which otherwise should apply.

The Court clarified how the OECD model and its commentaries as well as the reservations and observations should be used for the interpretation of a bilateral treaty.

For the purpose of interpreting a specific rule and term (''royalties'' under the 1969 Belgium-Portugal treaty), the Court adopted a static approach. Although payments were made from 1995 to 1997 and Portugal started protecting software as an analogous right to intellectual property in 1994, the Court considered that it was irrelevant to consider whether such protection should be considered equivalent to a ''literary work.'' Moreover, the Court considered irrelevant the adoption of a later reservation and ignored an observation introduced in 2008 after the signing of the Belgium-Portugal treaty, unless the other state agreed with such position in the bilateral treaty or presented an identical reservation or observation.

However, it remains to be seen whether the courts will accept that a nonresident entity is taxed on software income if the treaty was signed after 1994 (that is, when software apparently became protected in Portugal, analogously to a literary work), and if so, considering the current observation to the 2008 OECD model, in which terms.

The Court seems to reject an uncritical acceptance of an ambulatory interpretation of a tax treaty even if the articles of the OECD model remain unchanged but domestic law and the commentaries (reservations or observations) were substantially amended. From the Court's decision one may also infer that a change of domestic law that can alter the state's power to tax or new commentaries that may be considered elastic in allowing the expansion or reduction of the right to tax may seem irrelevant in the interpretation and application of tax treaties already in force. ◆