FEATURED PERSPECTIVES

Portuguese Arbitration Tax Court Rules on Notional Cash-Pooling Agreements

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Case 55/2012-T sheds new light on the way transfer pricing disputes are handled in Portugal. It is the first time a Portuguese court has decided on the transfer pricing aspects of cash-pooling agreements. The case was decided quickly by Portugal's recently introduced arbitration court, which rules on difficult and complex matters.

In this case, the arbitration court was presided over by three arbitrators — a well-known former Supreme Court judge, a law professor known for her studies in European tax harmonization and international tax law, and a professor of economics with articles published in the field of corporate income tax and accounting.

The court convened on May 15, 2012, and the final decision was dated December 24, 2012.

The case concerned the 2008 tax year, and the taxpayer was a company resident and incorporated in Portugal and a 100 percent subsidiary of a German company. The tax authorities assessed substantial corporate income tax because of a tax audit.

Plaintiff's Claims

The plaintiff claimed that the tax assessment violated the Portuguese transfer pricing regime because the tax authorities assumed that the plaintiff had provided a guarantee to its parent company, a related entity. However, according to the company, it could not be said that the subsidiary rendered a guarantee to its parent company under the cash-pooling agreement. The company also argued that the tax authorities were wrong in applying the comparable uncontrolled price method in order to obtain the arm's-length price under the cash-pooling arrangement.

Tax Authorities' Position

The tax authorities in their answer stated that the contract between the parent and the subsidiary had clauses that deviated from a cash-pooling contract and they believed it should be deemed a mix of different contracts. According to the tax authorities, the plaintiff in addition to providing a guarantee to its parent ended up financing the activity of the parent company in less favorable terms for the plaintiff than if it was not in an affiliated relationship.

Facts and Circumstances

The court considered that the following facts, among others, were proven.

In 2005 the plaintiff and its parent company entered into an agreement with a bank resident in the Netherlands.

Following a previous inspection made by the tax authorities for the 2005-2006 fiscal year, the plaintiff informed the tax authorities that as a result of the cash-pooling agreement, each party (the subsidiary and the parent company) held an individual bank account. The bank accounts were independent and each holder only could perform operations in its bank account. The funds available in each account contributed to a virtual consolidation in order to determine the overall balance. This determination of a virtual balance by the bank did not imply any change in the financial position of each party in relation to the bank and did not give rise

to a new financial operation between the participating entities. The service of the bank under this agreement was to apply a setoff system for the calculation of interest regarding debit balances and credit balances in bank accounts.

The Most Relevant Clauses

The most relevant clauses of the agreement for the purposes of the case are clauses 7 and 8, which state as follows:

Clause 7

Collateral

7.1 As security for the payment of the Secured Liabilities each of the Customers hereby pledges to the Bank, by way of a first ranking right of pledge, any and all present and future claims of the Customers on the Bank arising from or in connection with the Accounts.

7.2 By way of the execution of this Agreement the Bank acknowledges that it has been notified of the pledge made.

Clause 8

Set-Off/Enforcement

8.1 Each of the Customers which will at any time have debit balances in the Accounts, may set off any amounts due to the Bank arising from or in connection with the Accounts, with any amounts due by the Bank to each of the Customers which will at any time have credit balances in the Accounts arising or in connection with the Accounts.

8.2 When it wishes to receive payment of the Secured Liabilities, the Bank shall first seek recourse, based on a *pro rata temporis* basis, against the credit balances in the Accounts that are pledged to the Bank pursuant Clause 7.

Considerations of the Tax Authorities

It was further proven in the proceedings that in 2001 the plaintiff obtained a €40 million loan from the European Investment Bank (BEI) and provided a guarantee from a Portuguese bank to secure that loan. In 2008 the loan was still in force, still with its original conditions regarding the remuneration of the guarantee. The annual cost to the plaintiff for the guarantee rendered by a Portuguese bank to BEI was 0.375 percent.

Moreover, in June 2008 the plaintiff made a €2.305 million deposit in another Portuguese bank at a rate of 5.46 percent, for a period of 33 days. On the same date, the deposits of the plaintiff in the bank were remunerated at a rate of 4.25 percent.

In 2008 the average difference between the remuneration obtained by the plaintiff from its deposits in the bank and the conditions obtained in other operations between January and September was about 1.21 percent.

According to the tax authorities, the plaintiff was a company with a budget surplus, which enables it to dispose of funds for financial applications such as savings deposits. The good financial situation of the Portuguese subsidiary contributes to a better credit rating than that of its parent company, and the subsidiary will be able to obtain loans much more easily than its parent company. According to the tax authorities, since the Portuguese subsidiary had excess funds, its account should show zero or a credit balance at all times (debit balances not being allowed).

Inversely, the account of the parent company could have a debit balance (if the overall balance showed at all times zero or a credit balance). This means that the Portuguese subsidiary could not be financed under this agreement. Moreover, since the overall balance had to be positive or zero, the parent company would only obtain financing if the account of the subsidiary had enough balance to cover the needs of the parent company.

The tax authorities further argued that according to clause 7 of the agreement, the Portuguese subsidiary guarantees any eventual liabilities through present or future credits with the bank. The tax authorities consider that according to normal market conditions the bank is protected and guaranteed by the better credit rating of the subsidiary. Without the subsidiary, the parent company would pay a higher interest rate to finance itself. Further, this agreement was only possible because there was a relationship between the parent company and its subsidiary. Otherwise, the subsidiary would never enter into this type of agreement.

The tax authorities believed that those circumstances demonstrated a violation of the arm's-length principle, since a company without a special relationship would pay a higher interest rate if not for the guarantee of the Portuguese subsidiary. If these types of arrangements were to be legitimized, it would be bad for the economy. Economic groups would end up assuming dominant positions in the market because they would obtain better interest rates for financing their activity, benefiting from the intragroup relationship. The cash-pooling agreement in question showed a guarantee relationship rendering it a mixed contract. Regarding the transfer pricing method, the tax authorities referred to what was decided in a previous case concerning the same taxpayer, except for a past comparable transaction in which the interest rate was different.

The Preliminary Considerations

After summing up the positions of the parties, the court described the notional cash pooling in which there was no physical movement of the balances between the individual accounts, just a virtual consolidation of the balances for determining the interest rate

applicable to all accounts independent of the individual balances. The court explained that the interest rate foreseen in the agreement for credit balances was the base interest rate applied by the bank, and the interest rate that was applied to debit balances was the base interest rate applied by the bank plus 0.5 percent. According to the agreement, the credit interest rate was to be applied to debit balances if the overall balance of the accounts was positive. Inversely, if the overall balance of the accounts was negative, the interest over credit balances in the accounts would be calculated based on the interest rate applicable to debit balances in the accounts.

According to clause 7 of the agreement, the Portuguese subsidiary and the parent company guarantee any eventual liabilities through present or future credits with the bank, and clause 8.2 states that when the bank wants to receive its guaranteed passive, it should use the credit balances in the accounts guaranteed according to clause 7.

According to the court, it was not proven that these clauses ever operated during 2008. However, because during the life of the contract the subsidiary always had a credit balance, the tax authorities concluded that the subsidiary's bank deposits played a guarantee role of the payment of the parent company's debit balances. Moreover, the tax authorities concluded that the bank deposits of the subsidiary could not be openly moved because the parent company was the sole shareholder of the Portuguese subsidiary and therefore could determine the decisions of the subsidiary. The tax authorities further remarked that the subsidiary through its deposits allowed lower interest rates to be applied to the financing obtained by the parent company, concluding that the subsidiary's bank deposits were in practice guarantees. In light of these facts, the tax authorities considered that the remuneration obtained by the subsidiary in its accounts with the bank was not at arm's length.

The Application of the CUP Method

The tax authorities believed the CUP method was the most reliable method to determine the arm's-length price. Accordingly, the tax authorities used as a comparable a €40 million loan obtained by the subsidiary from BEI in 2001, in which a Portuguese bank issued a guarantee in 2008 at a rate of 0.375 percent.

According to the tax authorities, this guarantee should be considered comparable with the guarantee rendered by the subsidiary to its parent company in the cash-pooling agreement. However, also according to the tax authorities, there were particularities that distinguished the two operations: The Portuguese bank, while guarantor of the loan between BEI and the subsidiary, intervened just to guarantee that the economic interest of BEI was satisfied, while in the present transaction, the subsidiary, even though acting as guarantor of the credit operations between the bank and the parent company, also participated in the cash-pooling agreement.

Further, it was the amount of deposits made by the subsidiary that determined the amount of credit available to the parent company. Therefore, the bank deposits of the subsidiary determined the amount of credit available to the parent company, and in case of default by the parent company the bank could be compensated; consequently, the remuneration of the bank deposits should have considered not only the economic risk of the operation but also the cost of the opportunity to have made alternative applications. The tax authorities considered that a transaction that better reflected the arm's-length conditions in 2008 was an application made in another Portuguese bank for a period of 33 days in the amount of €2.505 million, at the rate of 5.46 percent.

On the same date, the deposits of the subsidiary in the bank were remunerated at a rate of 4.25 percent, resulting in an interest rate difference of 1.21 percent. Therefore, according to the tax authorities, the interest rate that should have been considered as remuneration for the guarantee of the subsidiary for the loans of the parent company in 2008 should have been 1.585 percent, determined by the sum of 0.375 percent (interest rate charged by the Portuguese bank on the loan contracted with BEI) and 1.21 percent (5.46 percent minus 4.25 percent).

The First Question

The court stated that the first question that must be decided was if the cash-pooling agreement should be considered a guarantee by the subsidiary to its parent company.

The court concluded that the cash-pooling agreement was more than a virtual merger of balances in order to optimize debit and credit interest, or existing clauses that created a true guarantee rendered by the Portuguese subsidiary to its parent company, the tax authorities argued. Therefore, according to the court, although the agreement was called cash pooling, its true nature was that of an atypical contract of a mixed nature.

The Second Question

The second question that the court addressed was whether the CUP method followed by the tax authorities was the most suitable method to determine the transfer price.

The court stated that the guarantee formed by the deposits of the Portuguese subsidiary with the bank was different from the guarantee chosen by the tax authorities to serve as comparable (the guarantee rendered by a Portuguese bank to BEI). In the cash-pooling agreement, the subsidiary did not assume the

same position of guarantor since the guarantee function attributed to the funds available in the bank account of the subsidiary only existed if the subsidiary deposited funds in its account and as long as it did not withdraw those funds. On the other hand, in the cash-pooling agreement there was no obstacle to the subsidiary's withdrawing funds whenever it wanted to. Therefore, the court concluded that the risk assumed by the subsidiary in making available funds in its bank account was inferior to the risk assumed by the Portuguese bank in the comparable situation chosen by the tax authorities.

According to the court, the CUP method can only be adopted if it allows the highest degree of comparability with the uncontrolled transaction, which is not what happened in this case. The court concluded that the method chosen by the tax authorities was illegal.

Regarding the use of the application made by the subsidiary in another Portuguese bank as a comparable, the court considered it had to be analyzed in detail.

The Plaintiff's Arguments

The Portuguese subsidiary argued that the CUP method would not be applicable in determining the arm's-length remuneration for the agreement. According to the Portuguese subsidiary, only the profit-split method would be appropriate, because it would be the only method suitable to understand the correct distribution of the benefits of the cash-pooling agreement between the parent company and its subsidiary. The profit-split method used by the Portuguese subsidiary is described in an article[1] that presented an algebraic model that presupposes debtor and creditor entities forming a cash-pooling agreement and it is sustained that only the comparison with identical cash pooling could provide the conditions for an arm's-length remuneration.

The Tax Authorities' Arguments

According to the tax authorities, the profit-split method was not a suitable method. The only suitable method, according to the authorities, would be the method that results from the comparison between the interest rate obtained by the subsidiary in the cash-pooling agreement with the interest rate that could have been obtained if it had placed its deposits in the market. Further, the tax authorities do not agree that the profit-split method could be corrected with the remuneration that it attributed to the guarantee function assumed by the subsidiary. As previously stated, the tax authorities considered that only market remuneration would be a suitable comparable. Consequently, the tax authorities made a comparison between the remuneration obtained in the cash-pooling agreement and the remuneration that would have been obtained if the funds were deposited in a bank.

The Decision of the Court

In the absence of any other comparable cash-pooling agreements, the court concluded that the profit-split method was the only suitable method. The court, quoting the above-mentioned article, stated:

> in deriving joint interest savings of the pool, it has been assumed that all pool members face identical market rates. However, in a situation in which some members are in a permanent borrowing position in the pool, credit risk may become an issue, which should be reflected in higher debit interest rates for those members.[2]

In interpreting this sentence, the court concluded that the model proposed in the article would require adaptations if a member of the cash-pooling agreement were in a permanent debit position, as was the case when the parent company was permanently in a debit position while the subsidiary was permanently in a credit position.

According to the court, to follow the tax authorities' reasoning, special care should be given in addressing the correct comparable. And the court concluded that the comparable chosen by the tax authorities — an application in another Portuguese bank — also does not achieve the highest degree of comparability required by Portuguese law. While the application made with the Portuguese bank was a short-term operation (33 days), the deposits in the bank in the cash-pooling agreement had a long-term perspective (from 2005 to 2008). The court also noted that proof of the highest degree of comparability in order to apply the CUP method to financial transactions should encompass an analysis of the following factors, among others: deadlines, amounts, risks assumed, guarantees, and positions of the parties in the agreements.

The tax authorities must demonstrate that the factors mentioned above were all taken into consideration and which factors affected the adjustments made.

The court concluded that the tax authorities did not demonstrate, beyond a reasonable doubt, that they considered all the factors as required by law.

Comment

This case should be framed in the more fundamental issue of transfer pricing of loans and guarantees. However, taking into consideration that the agreement between the parties was a mix of notional cash pooling and cross-guarantees, any transfer pricing analysis should bear in mind that cash-pooling agreements are

[1]Jörg Hülshorst, "The Profit Split Method in Cash Pooling Transactions," 14 *Tax Mgmt. Transfer Pricing Rep.* 698 (Dec. 21, 2005).

[2]*Id.*

agreements typically entered into between related parties and therefore it is not possible to find a similar transaction that would have been concluded with an independent third party at arm's length.

We believe the court decided correctly since the tax authorities did not demonstrate that the comparable uncontrolled transaction applied was capable of achieving the highest degree of comparability required by Portuguese law in order to apply the CUP method.

In a cash-pooling agreement, the companies of a group transfer their surpluses to a single bank account and may withdraw money from that bank account. Generally, all the companies of the group that participate in the cash-pooling agreement are liable for negative balances in the account. The movement of funds to and from the bank account by the participating companies has the nature of the granting and repayment of intragroup loans.[3]

Besides physical cash-pooling agreements, there are also notional or virtual cash-pooling agreements. The latter do not involve the physical transfer of funds, but just the setoff of the bank balances of the companies in the group. These types of agreements are concluded to optimize the overall position of the group regarding interest payments on finance and not to make intragroup loans. Typically, entering into a notional cash-pooling arrangement will include cross-guarantees by the companies of the group to maximize the available overdraft facility.

These types of agreements pose difficult problems both for taxpayers and tax administrations. More guidance should be provided by domestic tax authorities and the EU Joint Transfer Pricing Forum.

The integration of multinational enterprises and the type of transactions in question — cross-guarantees rendered by the parent and the subsidiary in case of default — renders it extremely difficult to apply traditional transaction-based methods to these types of arrangements.

According to the Portuguese tax process law, the courts in principle only have the power to determine if the method used was in accordance with the applicable law. Therefore, it is normal that the court did not discuss in detail the merits of the profit-split method followed by the taxpayer.

It seems that the profit-split method was the most suitable method to achieve an arm's-length remuneration, given the assets provided, the risks assumed, and the functions performed by the Portuguese subsidiary. However, this does not necessarily mean that such a method should be followed in all notional cash-pooling arrangements; the circumstances of each case should be carefully considered and factored into the determination of the transfer pricing method.

We believe the quality and promptness of this decision should be considered by taxpayers as an encouraging example when assessing their own willingness to manage transfer pricing disputes in Portugal. ◆

[3]For further developments regarding possible civil and criminal liability connected with these arrangements in Portugal, see Nuno de Oliveira Garcia and Andreia Gabriel Pereira, "Portugal," *International Cash Pooling: Cross-border Management Systems and Intra-group Financing*, 2011, p. 269.