One step forward, one step back in Portugal

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An overly broad definition of related parties, and the failure to legislate for APAs and cost contribution arrangements are some of the key omissions marring Portugal's efforts at transfer pricing reform

New provisions significantly changing Portugal's transfer pricing system are to be enforced on January 1 2002. The main reforms were enacted by Law 30-G/2000 of December 29 2000. The relevant transfer pricing provision is now article 58 of the Corporate Income Tax Code. The procedural rule that allows the tax authorities to make adjustments was also modified.

TRENDS IN PORTUGUESE TAX PRACTICE

The relevance of commercial relationships between and within multinational companies has been growing in importance since the 1980s. Typically, Portugal is an importer country: the major issue when considering cross-border transactions is the relevance of foreign investment.

The efforts of the tax authorities to keep up with the sophistication of international tax planning and to protect the taxation of Portuguese source income in Portugal have changed in their emphasis over the decades. In the 1980s, the authorities concentrated on limiting the percentage of acceptable royalties paid to one resident as a tax deductible cost and focused their efforts on withholding taxation on the transfer of technology income. The present emphasis is on challenging the effectiveness and deductibility of costs for cross-border services from multinational related companies, using the general legal provision which states that only indispensable expenses for the purpose of gaining or producing taxable income or for the maintenance of its source are deductible. Proof (and lack of proof) has mostly been the key argument used to challenge assessments, but treaty arguments may also be made. From the mid-1990s, the trend has been to concentrate on the enforcement of transfer pricing regulations based on global expansion in this area, notably amongst OECD countries.

TAX ADMINISTRATION EVOLUTION

One of the difficulties surrounding transfer pricing in Portugal has been the lack of specific legal provisions, and the deficit of skilled tax authority personnel with the background needed to deal with the technicalities. The failure of the tax authorities to develop a consistent practice has been a strong contributing factor to the uncertainty surrounding transactions between related parties, particularly in international transactions.

Until now, major internal tax court decisions addressed cost contribution agreements or cost sharing agreements. As stated by the Commission for the Reform of International Taxation in Portugal in its 1999 report, the courts have operated in a way that runs counter to OECD recommendations in this field. However, it seems that the Portuguese tax authorities are now focusing on OECD guidelines and dedicating additional resources to this area of practice, as well as initiating a process of exchanging information and know-how with foreign tax authorities. Time will tell whether or not these developments will reap benefits.

THE ARM'S-LENGTH PRINCIPLE: LEGAL BACKGROUND

Transfer pricing in Portugal has been tied to the arm's-length principle based on former article 57 of the Corporate Income Tax Code, and previously (from 1964 to 1989), on article 51-A of the Industrial Contribution Code (Código da Contribuição Industrial – CCI). None of these provisions, however, provided specific criteria according to which corrections could be made by the tax authorities when "conditions have been established between related parties different from those that would normally be established between independent parties". In fact, the previous legislation attracted considerable criticism and was accused of granting a wide margin for unguided decisions by the tax authorities, resulting from the use of undetermined concepts and the lack of methodology of comparability with unrelated party operations.

Notably, as mentioned by the Commission for Tax Reform in its report of April 30 1996, the legislation did not provide criteria for what could be viewed as "special relations between the taxpayer and another person" and the "establishment of different conditions from those that normally would be established." Both these criteria were included in the wording of previous article 57 of the Corporate Income Tax Code and article 51 of CCI.

In spite of this, article 80 of CPT (Código do Processo Tributário in force from 1991 to 1999) and article 77 of the General Tax Law, in force since January 1 1999, imposed a considerable burden on the tax authorities when correcting a taxable basis on the grounds of arm's-length breaking conditions. The authorities have an obligation to disclose, in any administrative proceedings against the taxpayer: a description of the related party relationship; a description of what were deemed to be the terms of the non-related equivalent operation; and a description of the amounts involved.

MAIN CHANGES

The main changes to be introduced as of January 1 2002 may be summarized as follows:

- an intensive and rather too broad concept of related parties;
- the arm's-length basis is imposed on all "related transactions";
- the need to follow comparable methods according to the OECD recommended methods;
- an obligation to fulfil certain formalities and documentation; and
- the introduction of the secondary adjustment principle to allow for domestic and international adjustments, for instance if the Arbitration Convention applies or the taxpayer can benefit from a double taxation agreement.

The new wording of the generic arm's-length principle directed towards both internal and international operations goes thus: "Business transactions, including, among others, transactions relating to goods, rights or services, as well as financial transactions which take place between a taxpayer and any other entity, whether or not subject to corporate income tax, with whom the taxpayer has a special relationship, should be subject to the same terms and conditions as would exist between two independent entities in comparable transactions".

Amended article 58 represents, broadly, the implementation into Portuguese law of the OECD Transfer Pricing Guidelines.

The new law was heralded as a way to decrease uncertainty in the transfer pricing area, on account of the broad concept of related parties, but the provisions to guarantee the position of the taxpayer appear to be ineffective. The new law is being criticized because it did not fully follow the specific recommendations of the Portuguese Commission for the Development of Tax Reform and the Commission for the Reform of Portuguese International Taxation; neither in the envisaged development of the legislation nor in administrative practice, notably creating obligations for the tax authorities. In its 1999 report, the Commission for Portuguese International Taxation Reform recommended:

- a clarification of the related party concept;
- full enforcement of the OECD Guidelines, under which specifically (i) the tax authorities have the burden of proof unless the taxpayer is unable to provide the documentation, (ii) a correlative adjustment procedure is introduced, (iii) powers are granted to the Portuguese tax authorities to negotiate advance pricing agreements (APAs), and (iv) safe harbours are established for such areas as interest or royalty payments; and
- regarding cost contribution arrangements, the OECD criteria would be introduced into law and therefore a cost contribution arrangement would be viewed not as income, but as the mere repayment of real incurred costs, exempt from withholding tax in Portugal.

Whilst the other recommendations were approved, although in a more stringent way (eg the definition of a related party), the APA and the cost contribution agreement recommendations did not gain acceptance.

The concept of related party

As part of its aim to provide certainty with regard to the related party criteria, to trigger a control relationship as well as a family relationship, the law has, in the authors' view, set out in excessive detail those situations where special relationships exist. In fact, one could ask what is not a related party! Considering in particular the Portuguese dimension, companies that do not have effective control of others could easily be subject to the burden of a special relationship link.

According to the new law, a special relationship is deemed to exist between two entities in situations in which one may exercise, directly or indirectly, a significant influence on the management decision of the other. The law then specifies that this is considered to happen between:

- an entity and its respective shareholders, and their spouses, ascendants and descendants, who hold, directly or indirectly, a participation of not less than 10% of shares or voting rights (the proposed law initially stated a 50% stake and a burden of proof on the taxpayer for shareholdings of between 25% and 50%);
- entities in which the same shareholders, their respective spouses, ascendants or descendants hold, directly or indirectly, a participation of not less than 10% of shares or voting rights in another entity;
- an entity and the members of its executive bodies, namely the board of directors (whatever its title), the financial supervisory board and their respective spouses, ascendants and descendants;
- entities in which the majority of the members of the board of directors or the financial supervisory board are the same person or, although different, are related by reasons of marriage, legally recognized union or direct descent;
- entities linked by a contract of subordination (where the management of a company is subordinated to the direction of another company, which may or may not dominate the former), or a contract of parity (where two or more companies not dependent on each other or on other companies create a group of companies under an agreement according to which they submit to a sole and common management) or other contracts of equivalent effect;
- companies that are in a dominion relationship as the latter is defined in the legal documents that impose the obligation to prepare and publicize consolidated financial statements; and
- entities between which, because of the commercial, financial, professional or legal relations that exist, are directly or indirectly established or practised, a situation of dependency occurs in the exercise of the respective activity, namely in the following situations:

i) exercise of the activity of one entity depends substantially on the licensing of industrial or intellectual property, or know-how, owned by the other;

ii) acquisition of raw materials or the access to sales channels for goods, markets or services for one entity depends substantially on the other;

iii) a substantial part of the activity of one can only be accomplished with the other or depends on the decisions of the other;

iv) the right to fix prices, or decisions of equivalent economic effect, relating to goods or services sold, rendered or acquired by one entity are, by contractual imposition, dependent on the other entity; or

v) within the terms and conditions of their commercial or legal relationship, one entity may influence the management decisions of the other, as a result of facts or circumstances outside the scope of the commercial or professional relationship.

The methods

The methods recommended by the OECD to ensure the highest level of comparability between the transactions that take place and other substantially identical ones, in normal market conditions or in the absence of a special relationship, were included in the wording of the new law. It is stated that it is necessary to ensure that the methods have "in view, among other things, the characteristics of the goods, rights or services, the market position, economic and financial situation and the business strategy of the companies involved, the functions performed by them, the assets used and the share of risk". The methods to be used should be:

- the comparable uncontrolled price method (CUP), the resale price method or the cost-plus method; or
- the profit split method, the transactional net margin method or other, when the first set of methods referred to above cannot be applied or, alternatively, they do not result in the most reliable measure for obtaining the result that would be achieved between independent entities.

Documentation

One of the major issues related to the new law is that it establishes a burden on taxpayers to maintain an extensive file on each transaction or series of transactions falling within the related party concept. Only when a taxpayer fails to meet one of its obligations will the tax authorities have grounds to initiate a tax proceeding challenging the agreed conditions.

The new wording of article 77 of the General Tax Law puts the burden of proof on the tax authorities for sustaining and describing the duties unfulfilled by the taxpayer, and establishes the alternative method to be followed by the tax authorities in their evaluation of the situation. The tax authorities are authorized to use the information they have in their files with no need to disclose the identity of the parties involved in the non-related transactions.

The taxpayer must maintain in good order the documentation regarding the policy adopted for transfer pricing, including the instructions relating to its application, and the contracts or other legal acts that exist with entities with whom there is a special legal relationship. This includes all amendments that have been made and information about the fulfilment of these instructions, documentation and information relating to those entities.

In its annual submission of accounts and tax information, the taxpayer must make a declaration of the existence or non-existence, in such financial period, of operations with entities with which there is a special relationship. This declaration must include:

- identification of the entities with whom a special relationship exists;
- identification and declaration of the value of the operations carried out with each one of the entities with whom such a relationship exists; and
- a declaration of whether or not the taxpayer organized the documentation relating to the transfer pricing policy followed at the time those operations were carried out, and confirming whether such documentation is maintained and that it was created in due time.

If the taxpayer concludes that the conditions set forth in the transfer pricing regulation were not fully followed in relation to operations with non-resident entities, it must make the necessary amendments to its taxable profits, responding to the tax consequences arising from making such an amendment.

The transfer pricing rules also apply to relations between a non-resident and its permanent establishment in Portugal, or between this and other permanent establishments of the same entity located outside Portuguese territory. The rules also apply to persons that simultaneously exercise taxable and non-taxable activities according to the Corporate Income Tax Code regime.

The correlative adjustment

The procedure is granted for the secondary adjustment internally. When the general director of taxes makes corrections by virtue of special relations between one taxpayer and another, in the determination of the taxable profits of the latter adjustments will be made to reflect the corrections made to the taxable profits of the former. Similarly, the director general of taxes is entitled to make the correlative adjustments when such adjustments are required in accordance with the terms and conditions established in international conventions signed by Portugal.

Until now, with the use of general legal provisions that considered certain expenses not to be indispensable and, therefore, not deductible, the tax authorities tried to avoid making adjustments and applying the treaties by considering the question as a purely domestic issue, but the case could be challenged under article 9 of the bilateral conventions signed by Portugal.

Rule to be issued by the Ministry of Finance

Despite the enormous complexity involved in evaluating who is a related party, the law failed to legislate on certain issues of considerable importance.

In fact, the application of the methods for determining transfer pricing, whether they apply to single operations or to a series of operations, as well as the type, the nature and the contents of documentation and the proceedings applicable to the correlative adjustment, are yet to be regulated by the Ministry of Finance.

At the time of writing, no such rule has been published, causing increasing dissatisfaction. Taxpayers are initiating a new calendar year uncertain of their duties in respect to their filings. The vacatio legis provided in the new law to prepare taxpayers for the new provisions failed in its scope due to the lack of essential elements for clarifying taxpayer obligations.

CRITIQUE OF THE PROVISIONS

Related party

Surprisingly, the main criticism regards the definition of related party. Designed to ameliorate the system, it introduced a whole new range of problems, on account of the wide-ranging and vague scope of the new parameters.

APAs

The recommendation from the Commission of introducing the possibility of negotiating advance pricing agreements with the tax authorities failed to materialise. This would have been an efficient supplement to traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues. APAs are not generically provided for in the Portuguese tax system, and the legislator has failed to take the opportunity to introduce them now.

Cost contribution agreements

Another issue that seems to be both a failure of the new law and that opposes the recommendation from the Commission relates to the question of cost contribution agreements. Cost contribution agreements could have been a very important tool considering the fact that many of the past court decisions on the arm's-length principle were related to challenges by the tax authorities of existing agreements. Therefore, the new law does not clarify the uncertainty in this area.

Safe harbours

A question that led to much debate was the introduction of what was to be a safe harbour: that is a rule related to permitted interest deductions on shareholders loans. It just so happens that Law 30-G/2000 introduced a provision into article 41 of the Corporate Income Tax Code (presently article 42 (1) (j) according to Decree Law No 198/2001 of June 3), according to which: "Interest and other forms of accrual on shareholder loans and loans made by the shareholders to the company, to the extent that they are in excess of the value corresponding to the Euribor 12-month reference rate on the day of creation of the debt or another rate to be issued by the Rule from the Minister of Finance (which until now has not been published)" are not deductible for tax purposes.

This was to be a safe harbour for taxpayers, which would have established a way to guarantee arm's-length conditions. But taxpayers opposed its limitations on interest, by fixing a limit rate that does not reflect market conditions, but which instead is significantly lower. The legislator disallows the interest deduction for shareholders in a way that would not have been agreed between non-related parties. For the time being, no other safe harbour exists, namely for royalties purposes.

Final comments

The most significant issue when considering the application of the permitted methods is that the Portuguese taxpayer must prepare the necessary documentation for each related transaction. The new law obliges taxpayers to define their own transfer pricing policy and the economic substance of the terms agreed, through proper documentation and the development in each company of a new type of management reasoning. Taking into account the lack of prepared information relating to market behaviour in the public domain, many taxpayers will face difficulties preparing their comparables or their authorized methods.

In conclusion, the main, serious flaw in the new law is its overly broad definition of related parties. While the new legislation creates more certainty in specific areas, it opens up a new chasm of doubt regarding the qualification of related parties – a clear example of one step forward and one step back in Portugal's legislative evolution.