PORTUGAL

Cost Contribution Arrangements

Francisco de Sousa da Câmara[1]

I. INTRODUCTION

Transfer pricing rules are currently being reviewed, both legislatively and administratively.[2] Liberalization of the Portuguese economy has brought new cases before the tax authorities and ultimately to the tax courts. After the important income tax reform at the end of the 1980s, it was quickly understood that there was a need to rethink international tax policy and to initiate a different pattern that would be more consistent with the Portuguese economy and its status as an EU and OECD Member State.

The Portuguese Report of the Committee of Experts on International Tax Issues (hereinafter: the Report), issued in 1999, has recommended adherence to the OECD Transfer Pricing Guidelines (hereinafter: OECD Guidelines), as well as the adoption of precise definitions of the terms "associations of enterprises" and "special relationships".[3] In addition, other previous studies[4] and tax reports[5] presented to the Ministry of Finance alluded to the need to accept the OECD Guidelines as a guiding light in the orientation of future domestic legislation and the interpretation of conventional rules.

The recent income tax reform published at the end of 2000 significantly amended some concepts so that they are now along OECD lines (e.g. the concepts of permanent establishment and transfer pricing methodology). Prior to this tax reform, the key concepts for a tax adjustment (i.e. the definition of a "special relationship", the methods of evaluation to determine whether or not an operation or transaction satisfied the arm's length principle, transfer pricing documentation and the procedures for correlative adjustments) did not exist or were not regulated issues. This gap gave rise to discretionary decisions and to contradictory court decisions, which not only bred distrust between the tax authorities and taxpayers but also led to misunderstandings and confusion of concepts within the transfer pricing area.

Although it is expected that new regulations will reduce the lack of clarity and the uncertainty in this field, one still notices in the current rules the resonance of a source state concerned with extending specific concepts (e.g. special relationship or permanent establishment) beyond OECD borders.[6]

II. COST CONTRIBUTION ARRANGEMENTS

A. General approach

In spite of the specific recommendations contained in the Report,[7] cost contributions arrangements (hereinafter:

1. Partner with Morais Leitão, J. Galvão Teles & Associados, Lisbon; visiting professor of international tax law at the Universidade Nova, Lisbon.

2. Law 30-G/2000 of 29 December 2000 amended Art. 37 of the Corporate Income Tax Code (hereinafter: CITC). More recently, on 26 April 2001, the government decided to approve the new version of the CITC which was published as an appendix to Decree Law 198/2001 of 3 July 2001. Currently, the main transfer pricing rule (former Art. 57 CITC) is foreseen in Art. 58 CITC. This new regime will become effective on 1 January 2002. Meanwhile, a rule to be issued by the Ministry of Finance will be published to define the following points:
- whether or not the application of the methods to determine the transfer price will apply to single transactions or to a series of transactions;
- the type, nature and contents of transfer pricing documentation that taxpayers must maintain in good order; and
- the proceedings applicable in the case of a correlative adjustment.

3. The Report on the Tax Reform concerning International Tax Issues was presented to the former Minister of Finance in March 1999 and is published in *Ciência Técnica Fiscal* 395 (1999(3)), at 103-182. This Committee of Experts was created and appointed by the Minister of Finance under Decision 7.135/98 of April 1998, published in the Official Gazette, II Série, 100, 30 April 1998.

4. Report of the Committee for the development of Tax Reform, *Relatório da Comissão para o Desenvolvimento da Reforma Fiscal*, Ministry of Finance, (April 30, 1996), at 659-662.

5. Report on Transfer Pricing prepared by the tax authorities working group in charge of preparing the amendments to be introduced in the Corporate Income Tax Code (Lisbon: 1999).

6. See the Report, *CTF* 395, at 158 et seq.; Arts. 5 and 58 CITC. In addition, the principle of attraction of a permanent establishment was maintained in Art. 3°-(3) of the CITC to be applied in cases where there is no applicable treaty.

7. The Report recommended that Portuguese law should:
- recognize that in the case of CCA meeting the requirements mentioned in the OECD Guidelines, no withholding tax will apply in Portugal because contributions are not income;
- take the position that contributions based on a turnover criterion are valid because the law should allow it to be deemed that the participant's contribution corresponds to the participant's expected benefits from such arrangements;
- recognize that contributions are tax deductible in cases where the above mentioned criteria are respected, considering that the participant will share the results derived by the CCA owning a share of those results;
- admit that a resident company that buys in to an existing CCA should be allowed to deduct its contribution for tax purposes, recognizing this payment as a reimbursement taking in consideration that with this contribution the buy-in company intends to buy a share in the results derived by CCA; and
- apply the rules applicable to associated enterprises to CCAs.

One of the six members of the Committee of Experts on International Tax Issues, also belonging to the Portuguese Center for Fiscal Studies (a public entity that is part of the Ministry of Finance, hereinafter: CFS), did not endorse this recommendation, on the grounds that CCAs deserve more detailed treatment. However, a Transfer Tax Committee organized from within the tax authorities (consisting of only three members, one of whom is the above-mentioned CFS member) recommended, in line with the OECD Guidelines, that:
- tax law should contain particular provisions about the conditions of deductibility of contributions made by companies under a CCA relating to R&D;
- those conditions should be guided by the same criteria applicable to the treatment of expenses of an identical nature (R&D) when the latter are directly realized by the company and the contributions should be in a direct proportion with the benefits connected with the right to use the results of the projects to be developed;
- the law should clarify that contributions made under a CCA are not tax deductible when the taxpayer is making payments to the same company or other group companies, explicitly or implicitly (e.g. included in the price of

CCAs) were not defined by law or administrative regulations. Theoretically, the OECD concept of a CCA is, as a rule, respected by all the relevant parties, namely the tax authorities, taxpayers and the courts. For this purpose, a CCA is considered to be a framework agreed among business enterprises to share the costs and risks of developing, producing and obtaining assets, services or rights, and to determine the nature and extent of the interest of each participant in those assets, services or rights.

However, practice shows divergent approaches and interpretations. In spite of Portuguese tax literature emphasizing the need to recognize CCAs within the OECD Guidelines, in its absence there are numerous situations where the tax authorities and the tax courts have taken divergent and contradictory positions on these issues.

In the author's opinion, the main discussions have derived from three principal factors:

- traditionally the tax authorities were not very well prepared to analyse and understand these very specialized projects and taxpayers did not always provide clear and detailed documentation translated into Portuguese;
- based on a "source state" concept, the tax authorities particularly feared tax evasion by indirect transfers of profits, namely through the use of aggressive transfer pricing plans or other equivalent arrangements and, not unusually, taxpayers were victims of the assimilation of concepts by the tax authorities; and
- the existence of grey areas within this concept and the completely divergent taxation of fees for services or technical assistance and of royalties for know-how or intellectual and industrial property, opened up the potential for conflicts whenever things were not absolutely transparent and clear. Moreover, and apart from withholding tax issues, problems arose with the deductibility of such contributions.

One should bear in mind that although transfer pricing is not an exact science, it is expected that "in a CCA each participant's proportionate share of the overall contributions to the arrangements will be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement...".[8] Within this context the tax authorities also discussed the right to deduct those contributions as tax costs, assuming that they were not indispensable for the creation of profits or gains, or for the maintenance of the productive source of income.

B. Jurisprudence

Subsidiaries or branches of multinational companies are often required by the parent or some other group company to provide funds to meet costs incurred by the group in the course of providing intra-group services or group research and development (hereinafter: R&D). As a rule, these payments are not connected with specific services solely performed for the benefit of the payer and may take the form of a cost funding or a cost sharing agreement.[9]

Notwithstanding the existence of previous jurisprudence, the tax court case concerning Shell International Petroleum Company Limited and Ford Lusitana during the late 1980s and early 1990s motivated new interest in CCAs and their tax treatment.[10] Nevertheless, the main discussions before the courts dealt with a reality slightly different from that of CCAs and focused rather more on intra-group services agreements, which involved commercial intangibles such as know-how.

The tax treatment of know-how, technical assistance, services or the refund of costs was (and still is) completely different and such facts fuelled discussions, particularly because the contractual clauses and complementary documentation and evidence did not seem clear enough to be interpreted in the same way by the taxpayer and the tax authorities.

In the end, in the last cases discussed in the Administrative Supreme Court, the Portuguese subsidiaries of Shell and Ford were unable to convince the tax authorities and the Tax Court that they were merely refunding costs to other members of the group that performed services and undertook a research activity on behalf of several group companies (including the Portuguese subsidiaries). Once the taxpayer had failed to prove this (i.e. it was not shown that a pre-CCA had been put in place), the discussion focused on the classification of the payments as either fees for services (or technical assistance) or royalties, taking into consideration that the latter, contrary to the former, were subject to a withholding tax in Portugal. The facts in the majority of Shell cases[11] brought before the Tax Courts were as follows:[12]

---

the acquired assets), paying royalties by the use of assets or identical rights, or with identical goals and nature to the ones that are the object of the CCA; and

- regulations should develop the minimum requirements for the tax deductibility for tax purposes of such contributions under a CCA, notably the following: (1) the existence of a written agreement (translated into Portuguese) that identifies all the participants, the activities and the specific projects that are its object, and the duration of the CCA; (2) documentation connected with the methods to determine the contribution amounts and the key under which the allocation is made among all the participants; (3) the criteria to determine the expected benefits for each participant and the forecast measures used in its quantification; and (4) the mechanisms of adjustment of contributions among the participants, notably through buy-in, compensatory and buy-out payments.

8. See Sec. 8.3. of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 2001) (hereinafter: OECD Guidelines).

9. Cost contributions may take the form of payment of a proportion of the relevant costs incurred by the parent or other entity, the proportion being based on, for example, the relation between the turnover of the member and the total turnover of the group as a whole (cost funding). Alternatively, the contribution may be made under a fixed and detailed arrangement providing for the costs of, e.g. specific research or development to be borne in a particular proportion by the member companies concerned in return for specific benefits being made available to them in proportion to their contribution (cost sharing). See Susan M. Lyons (ed.), *International Tax Glossary*, 2nd ed. (Amsterdam: IBFD, 1992).

10. *Case Shell International Chemical Company Limited v. the tax authorities (Fazenda Pública)*, Appeal 11.935, Decision of 21 February 1990, *Fisco* 18/29 and *Ford Lusitana, SARL v. the tax authorities (Fazenda Pública)*, Appeal 2.952, Decision of 9 November 1988, Ap. DR, at 58.

11. The audit to Shell Portuguesa has shown that this company entered into an agreement with Shell International Chemical Company Limited under which the former made some payments to the latter during some years. The tax authorities made a few additional assessments considering that payments made by Shell Portuguesa to Shell International Chemical Company Limited should not be characterized as a reimbursement of costs but as a payment of income, and the latter should be qualified as royalties and not as fees related to services rendered by Shell International.

12. Currently fees related to services are also subject to withholding tax, unless it is otherwise provided for under an applicable income tax treaty. The facts were

- both companies (payer and payee) belonged to the same group of companies and they had common interests;
- in order to have access to opinions, services and assistance to be provided by the non-resident company (Shell International), the Portuguese company (Shell Portuguesa) signed a service agreement with the non-resident company;
- in accordance with the contract signed within the Shell Companies Group, the Portuguese company had to pay to Shell International an annual amount corresponding to a certain proportion of the total costs borne by Shell International. Such proportion was calculated taking in consideration the annual turnover of oil products obtained by each one of the companies that signed such agreement;
- some amounts corresponded directly to costs incurred with the development of some products and their applications;
- Shell International received those amounts from the different group companies spread over different countries in order to cover its own costs and expenses and did not add any profit margin; and
- any patents or inventions that were available to Shell Portuguesa without the need for any further payment.

Nevertheless, the Tax Courts concluded that the taxpayer had not sufficiently proved that:[13]

- payments merely corresponded to a specific refund of expenses previously incurred by Shell International;
- there was a common fund of all the companies that entered in such agreement; and
- know-how was not transmitted to Shell Portuguesa.

This decision was anticipated and followed by other decisions where the Administrative Supreme Court (Tax Section) did not recognize the existence of a CCA and qualified the amounts paid abroad as royalties.[14]

These cases unequivocally showed that the tax authorities and the courts were not convinced that the Shell Portuguesa proportional share of the overall contributions to the arrangement were consistent with its share of the overall expected benefits to be received under the contact.

Although the costs were well identified, the benefits received or expected to be received as the outcome of R&D services were not precisely identified. Here, one should recognize that the issue was not whether or not intra-group services had in fact been provided. The facts did not clearly identify the economic and commercial advantages obtained by Shell Portuguesa, nor specify the precise types of services or opinions rendered to the Shell Portuguesa. Nevertheless, the tax authorities never discussed whether the intra-group services had been rendered effectively or if the intra-group charge for such services was in accordance with the arm's length principle. The moot point of discussion was only centered on the fact of classifying the payment as a refund of a cost or as a royalty.

In the end, the Supreme Court concluded, quite superficially, that these payments were intended to remunerate know-how granted to Shell Portuguesa and, therefore, should be characterized as royalties. Several decisions were then taken contradicting two previous decisions of 1976 and 1985[15] which held that such payments corresponded to a mere refund of costs. This new judicial approach prompted strong criticism and the development of a new tax literature.[16]

Critics raised two main objectives. First, regarding the facts, they believed that although the facts were not clearly evidenced, the court had also not attempted to clarify them with persistence. In such an area, without precise facts it is easy to go off target. Second, within the context of the applicable law, one could also easily argue that OECD Guidelines were not considered, that treaty provisions were overridden by domestic provisions, and even that the interpretation and application of domestic concepts of services, technical assistance and know-how escaped a thorough examination.

At least jurisprudence contributed in this case by helping to identify the problems and by giving rise to discussion.

C. Tax treatment of CCAs

Early jurisprudence must not prevent multinationals and, in particular, Portuguese subsidiaries, from entering in a CCA, but certainly should lead them to appraise the situation with special attention. First, it seems crucial to distinguish a mere intra-group services agreement from a CCA. Remuneration of effective or potential intra-group services must be characterized in view of the services performed which need to be identified and measured. At this stage, it seems relevant to use the OECD Guidelines in order to gain a clear picture of the issues. The *Shell* and *Ford* cases showed, in the author's opinion, that:

defined by the Tax Courts of first or second instances depending on the cases and were mainly based on the written agreements signed between Shell Portuguesa SA and Shell International Chemical Company Limited on 15 February 1963 or Shell Portuguesa and Shell International Petroleum Company Limited on 25 July 1969.

13. *Shell International Chemical Company Limited v. the tax authorities* (*Fazenda Pública*), Appeal 59.413, Decision of 14 February 1989, *CTF* 354, at 257-272 (see in particular Paras. 9, 11 and 13); and *Shell International Petroleum Company Limited v. the tax authorities* (*Fazenda Pública*), Appeal 59.511, Decision of 23 May 1989, *CTF* 356, at 275-282 (see in particular pages 278 et seq.).

14. The first two decisions accepting CCAs (*Case Standard Eléctronica* – Rec. 467, Decision of 19 May 1976, AD 179/1440; and *Case Shell International Company Limited* Rec. 3.101, Decision of 13 November 1985, AD 291/291) and their tax consequences (mainly, that the payments made abroad corresponded to the reimbursement of costs and should not be classified as income) were contradicted in several other cases decided in favour of the tax authorities that classified such payments as know-how. See e.g. a case brought by *Shell International Chemical Company Limited* (Proc. 59.413, Decision of 14.2.1989, *CTF* 354/257 and Appeal 11.935, Decision of 21 February 1990, *Fisco* 18/29) and a case of *Ford Lusitana, SARL* (Proc. 54.679 – Decision of 4 July 1984, *CTF* 313-315/455 and Appeal 2.952, Decision of 4 November 1987 *Ap. D.R.*, at 761).

15. Cases *Standard Eléctronica, SARL* and *Shell International Company, Limited.* (See the two decisions accepting CCAs mentioned in note 13.)

16. Very critical comments on the Administrative Supreme Court decisions of 21 February 1990 (Appeal 11.935) were immediately published. See Miguel Teixeira de Abreu "Royalties e pagamentos de investigação e pesquisa", *Fisco* 18 (March 1990). See also William T. Cunningham and Carlos Loureiro, "Tratamento fiscal da imputação a sociedades Portuguesas dos custos centralizados no âmbito de grupos multinacionais", *Fisco* 50 (January 1993) (the first Portuguese article on CCAs).

- CCAs were not clearly identified; and
- intra-group service agreements including a research element, where costs are shared, may not be characterized automatically as know-how agreements that give rise to the payment of royalties.

Second, in the absence of specific domestic rules for CCAs, one must rely on general legal provisions. The general rule regarding business expenses is that a deduction is allowed for all expenses necessary for the production of taxable income or to maintain assets producing such income. Items specified by the corporate income tax code as being demonstrably indispensable for the creation of profits or gains, or for the maintenance of the source of such income include the following:

- purchase or production costs for good or services on revenue account, such as costs for materials, labour, energy, other manufacturing, conservation or repairs;
- administrative costs, including remunerations, subsidies, pensions, or complementary retirement subsidies, rents and fees; and
- costs of analyses, rationalization, research and consultancy.

In a certain way it seems clear how the costs of an operation should be identified and segregated. So, following this path, one must then determine whether or not these payments correspond to the refund of a cost assumed by a third entity. This means that one must clarify whether this remuneration should be regarded as profit (or other income – e.g. royalties) obtained by another entity or if it was a mere refund of a CCA.

As are other OECD member countries, Portugal is encouraged to follow the OECD Guidelines in domestic transfer pricing practices and in the interpretation of its own domestic rules. In this context it is also to be expected that the taxpayers and the tax authorities, being aware of the OECD Guidelines, will make a joint effort to respect the same principles. Having said this, it seems pertinent to identify a CCA under the current domestic rules. Although the OECD Guidelines should be observed, they also need to respect the domestic rules. In addition, CCAs should be as transparent and clear as possible in order to avoid misunderstandings.

Within this context it is important to do the following:

- define and identify the type of CCA, namely its object and the main rights and obligations of each participant;
- define and identify the legal and economic rights of each participant and the criteria to determine the expected benefits that are effectively attributed to each participant, as well as the forecast measures in its quantification. The allocation of contributions (as adjusted for any balancing payments made among participants) must be properly made, considering the expectation of benefits to be received by each participant under the CCA;
- specify that compensation contributed by the participant is the benefit that it expects to derive from the pooling of resources and skills;
- be able to show whether benefits were or were not obtained under the CCA. After being in place for some years, the tax authorities may indeed question whether the parties would continue with their participation in the CCA if they had been independent enterprises;
- respect the OECD Guidelines (Chap. VIII–C) in applying the arm's-length principle (namely to determine the amount of each participant's contribution, to determine whether or not the allocation is appropriate and to determine the tax treatment of contributions and balancing payments); and
- pay attention to the entry, withdrawal or termination of participation in a CCA, in particular any consideration in the form of buy-in and buy-out payments and other conditions and clauses that may be inserted in the CCA.

All these elements should be evidenced by written agreements (translated into Portuguese in the case where it is necessary to present such documents to the tax authorities), along with other documentation related to the R&D activity (e.g. financial and economic statements connected with the arm's length methods). It is necessary to determine the contribution amounts and the key under which the allocation is made among all the participants, as well as the criteria to determine the benefits already obtained (at the time the audit is made) or the benefits that each participant still expects to obtain in the future. As stressed in the OECD Guidelines:

> ... prudent business management principles would lead the participants to a CCA to prepare or to obtain materials about the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle. Implicit in this is that each participant should have full access to the details of the activities to be conducted under the CCA, projections on which the contributions are to be made and expected benefits determined, and budgeted and actual expenditures for the CCA activity. All this information could be relevant and useful to tax administrations in the context of a CCA and taxpayers should be prepared to provide it upon request.[17]

Although information to be presented to the tax authorities depends on the specific facts and circumstances that relate to each participant in the arrangement, the elements described in Paras. 8.42 and 8.43 of the OECD Guidelines should be scrutinized in detail when one intends to implement a CCA.[18] Nevertheless, it is important to emphasize

17. OECD Guidelines, Para. 8.41.

18. The following information would be relevant and useful concerning the initial terms of a CCA:

- a list of participants;
- a list of other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity;
- the scope of the activities and specific projects covered by the CCA;
- the duration of the arrangement;
- the manner in which participants' proportionate shares or shares of expected benefits are measured and any projections used in this determination;
- the form and value of each participants' initial contributions and a detailed description of how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions;
- the anticipated allocation of responsibilities and tasks associated with the CCA activity between participants and other enterprises;
- the procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA; and
- any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes the economic circumstances.

once again the existence of the Portuguese CCA rules and the fact that Portuguese jurisprudence is very contradictory. In order to reduce the tax risks in Portugal, an international arrangement that involves a Portuguese participant should respect the OECD Guidelines in substance and in form. At the same time, the Portuguese participant should be able to show that:

- it is not remunerating know-how;
- payments correspond to a specific refund of expenses and costs; and
- a common fund of all the participants exists.

This proof should not only be based on a written agreement but should also be supported by other documentation available to each CCA participant.[19]

Elimination of risks may also be achieved through the filing of a request for a binding ruling for the case at hand. All facts should be described in order to allow the tax authorities to give their express opinion, which, unfortunately, may take more than one year to be granted. In the case no answer is received within the term of six months following the date in which the application is delivered, the tax authorities are prevented from invoking and applying anti-avoidance measures to this operation, in the future.[20]

III. VALUATION OF TRANSACTIONS BETWEEN RELATED PARTIES

A. Possible adjustments

Transactions entered into between associated enterprises or, more precisely, between entities related by special relationships, may be scrutinized by the tax authorities if it is found that the same terms and conditions that would exist between two independent entities in comparable transactions were not respected. Up until now (2001), the following four requirements were to have been met in order to allow the application of transfer pricing rules:

- association of companies or entities with a commercial or financial relationship different from that which would have been established between independent entities;
- special relationships between these entities;
- legal possibility to adjust taxable income; and
- identity of operations (the nature, as well as the entities involved, the object, the circumstances and goals to be achieved).

Nevertheless, tax law did not adopt an express and specific definition of "associated enterprise", nor did it define a "special relationship" as part of the methods for evaluating transactions. In addition, it also did not specify the type of transfer pricing documentation that should be maintained. This state of affairs increased disputes and uncertainty.

The income tax reform of 2001 amended the main transfer pricing provision (under the CIT Code),[21] although this regime will only apply to tax periods starting on or after 1 January 2002. The previous gaps were closed within very restricted boundaries; although recognizing the use of OECD concepts, it is also noticeable that several terms (namely the definition of "special relationship") are unrecognizable internationally. They are simply the product of the recent Portuguese tax reform that is still rather "extremist" in this regard.

B. Methods of evaluating transactions

In determining the terms and conditions that would normally apply between two independent entities, the taxpayer should adopt a method or methods suitable 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, taking into consideration factors such as the characteristics of the goods, rights or services; the market position, economic and financial situation, and business strategy of the companies involved; the functions performed by them; the assets used; and the share of risk. The method or 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 another method, when the above three methods cannot be applied or, alternatively, if they do not result in the most reliable measure to obtain the result that would be achieved between independent entities.

C. Definition of the "special relationship"

A special relationship is deemed to exist between two entities in situations in which one of them may exercise, directly or indirectly, a significant influence on the management decision of the other, which notably is considered to happen between:

- an entity and its respective shareholders, as well as their spouses, ascendants and descendants, which hold, directly or indirectly, a participation of not less than 10 per cent of shares or voting rights;
- entities in which the same shareholders, respective spouses, ascendants or descendants hold, directly or indirectly, a participation of not less than 10 per cent of shares or voting rights;
- an entity and the members of its executive bodies, namely the board of directors (whatever its title), the

Over the duration of a CCA term, it could be useful to specify the following information:

- any change to the arrangement (e.g. in terms, participants, subject activity) and the consequences of such change;
- a comparison between projections used to determine expected benefits from the CCA activity with the actual results (with regard, however, to Para. 1.51 of the Transfer Pricing Guidelines); and
- the annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made over the term of the CCAs, and a detailed description of how the value of contributions is determined and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions.

19. In addition, one should bear in mind the constraints and restrictions pointed out by the Transfer Tax Committee. See note 6. If these issues are regulated, either by law or administratively, it is possible that the mainstream will follow that precise path.

20. See Arts. 68° General Tax Law and 63(8) Code on Tax Procedure and Appeals.

21. Art. 58 CITC.

financial supervisory board, and the 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 persons or, although different, are related by reason of matrimony, 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 dependent on neither each other nor on other companies, create a group of companies under an agreement by which they submit to a sole and common management), or other contract of equivalent effect;
- companies that are in a unified control (*dominium*) relationship[22] as the latter is defined in the legal documents which 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, directly or indirectly established or practised, a situation of dependency exists in the exercise of the respective activities, namely in the following situations:
  - the exercise of the activity of one entity depends substantially on the licence of industrial or intellectual property, or know-how, owned by the other;
  - the acquisition of raw materials or the access to sales channels for goods, markets or services for one entity depends substantially on the other;
  - a substantial part of the activity of one can only be realized with the other or depends on the decision of the other;
  - the right to fix prices or take decisions of equivalent economic effect, relating to goods or services sold, rendered or acquired by one entity is, by contractual imposition, dependent on the other entity; and
  - 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 a commercial or professional relationship.

The application of the methods to determine the transfer price, whether they apply to a single transaction or to a series of transactions, as well as the type, nature and contents of documentation to be provided, and the proceedings applicable in the case of a correlative adjustment, will be regulated by a rule to be issued by the Ministry of Finance, which rule is expected to be published during 2001.

IV. CONTRIBUTIONS TO R&D PROJECTS

In the absence of CCA provisions, the conditions of deductibility of contributions made by companies under CCAs must follow general rules, although the contributions may also benefit from particular domestic R&D provisions. Basically, if these expenses are directly realized by the companies, it is expected that such contributions will be in direct proportion to the benefits connected with the rights to use the results of the R&D.

The special tax regime concerning contributions to R&D projects was created by Decree Law 292/1997 of 22 October 1997, which was recently amended by Decree Law 197/2001 of 29 June 2001.

An investment credit is available for resident entities and Portuguese permanent establishments of non-resident entities in respect of qualifying R&D expenses. The amount creditable against the taxpayer's CIT liability is the sum of the basic investment tax credit equal to 20 per cent of the qualifying expenses incurred plus an additional credit equal to 50 per cent of the amount (limited to PTE 100 million) by which the qualifying costs for the relevant year exceed the average R&D expenses incurred in the two preceding years. Any unused investment tax credit may be carried forward for six years.

For purposes of this regime:
- research expenses (R) are those incurred by the taxpayer for the purpose of acquiring new technical and scientific knowledge, provided that such activities take place within Portuguese territory; and
- development expenses (D) are those incurred by the taxpayer for the purpose of exploiting research results or other scientific or technical knowledge to discover or improve raw materials, products, services, or manufacturing processes, provided that such activities take place within Portuguese territory.

Among others, the following categories of expenses qualify as R&D expenses, provided that the R&D activities take place within Portuguese territory:
- acquisition of fixed assets (with the exception of buildings) which are newly created or acquired and directly related to R&D activity;
- personnel expenses directly related to R&D tasks;
- management and directors' expenses related to R&D;
- operating expenses up to a maximum of 55 per cent of personnel expenses;
- expenses incurred in connection with R&D contracts signed with certain public entities;
- contributions of capital to R&D institutions;
- costs related to the registration and maintenance of patents;
- certain patent acquisition costs; and
- expenses incurred from audits of R&D projects.

V. CONCLUSION

Despite several recommendations within the tax administration itself, CCAs were not regulated either by law or by rules when the new transfer pricing rules to be applied from 1 January 2002 were published. In the absence of specific legislation, general provisions concerning the deductibility of costs and particular rules concerning R&D projects should be respected as the main domestic guidelines.

22. See Art. 486° Portuguese Companies Code under the epigraph "Companies under a unified control [*dominium*] relationship".

The concept of a CCA as defined and explained by the OECD Guidelines is expected to be recognized and respected by taxpayers, the tax authorities and the courts. However, recent court decisions regarding CCAs are contradictory both in terms of previous decisions and vis-à-vis the international concepts themselves. Although some decisions seemed to have arisen from factual or legal mistakes, others expressly recognize that taxpayers failed to meet their burden of proof. In this context and bearing in mind the mutual distrust between taxpayers and the tax authorities, the ability to prove the facts that may allow qualification of an arrangement as a CCA is crucial. Taxpayers should be able to:

- prove that the CCA respected both domestic and treaty rules, namely those that allow qualification of the contributions as deductible expenses or costs and not as the remuneration of services, technical assistance or royalties;
- explain the assimilation or similarity of these expenses or costs with other R&D expenses that are recognized within the Portuguese legal framework regarding specific incentives;
- show that the specific arrangement between the group companies respected the arm's length principle which does not allow transfer pricing adjustments;
- prove that the CCA concept as it is explained and developed by the OECD Guidelines was respected and put in place effectively; and
- present the relevant documentation, including the type of information mentioned in domestic rules and in Paras. 8.42 and 8.43 of the OECD Guidelines, as translated into Portuguese.

Cumulative Index

ARTICLES

COMPARATIVE SURVEY

Cost Contribution Arrangements

[*to be continued on page 236*]