PORTUGAL

# Supreme Court Rules on the Distinction between Royalties and Fees

## Decisions of 20 February 1991 and 28 October 1998

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In two cases having similar facts, Portugal's Administrative Supreme Court (*Supremo Tribunal Administrativo* (STA)) has taken two different decisions. The decisions[1] have shed some light on the characterization of income derived from a lease management agreement, a franchising agreement or other mixed agreements which incorporate an element of know-how.

Both cases involved M.J. Pestana – *Sociedade de Turismo de Madeira SA* (hereinafter: "the plaintiff"), who, during the period covered by the cases under discussion, was the owner of a hotel which for a limited contractual period became known as the Madeira Sheraton Hotel, and the Portuguese Ministry of Finance. The first case concerned the imposition of industrial tax[2] for the years 1982 through 1985 and the second case related to the imposition of the same tax for the years 1986 and 1987.

The main issue in both cases concerned the characterization of the payments made by the plaintiff to the Sheraton Overseas Management Corporation (SOMC) with whom the plaintiff signed a management agreement relating to the Madeira Sheraton Hotel.

In the first decision, handed down on 20 February 1991, the plenary session of the STA adopted the view that those payments had to be considered royalties. However, a few years later, on 28 October 1998, the STA (now in its lowest section) concluded that those payments could not be characterized as royalties, but should rather be taxed as fees for services rendered by the SOMC. The first decision followed the tax authorities' view while the second upheld the arguments presented by the taxpayer.

In both cases, the issue was limited to the question of whether or not payments made abroad should be allowed or disallowed as a deductible expense for the plaintiff. In fact, it would be possible to raise other issues based on the characterization of the payments with respect to withholding tax or the subjection of such payments to different VAT regimes.

### THE FACTS

#### Decision of 20 February 1991

On 30 March 1970 an agreement was signed between the plaintiff (the owner of Hotel Madeira Sheraton) and Sheraton Overseas Company Lda (hereinafter: SOC or the operator). According to this agreement, the first party gave the second party the management and development of a hotel (Madeira Sheraton) after its construction, the start-up of the business and the opening of the hotel to the general public. Later, the SOC assigned the position of manager and developer of the hotel to the SOMC.

According to Article 6 of this contract it was agreed that:

> within the terms of this agreement the owner contracts the operator as exclusive manager and developer of the hotel during the period of operation. As such, the operator will have absolute control of the operation and direction of the hotel, including [...] all the operations of promotion and advertisement related to the hotel. ....the operator will develop the hotel and all of its facilities and activities, in the manner which is usual for first class hotels in the Sheraton group.

According to Article 8, "the operator will plan all the necessary advertising for the success of the hotel. The operator will announce that the hotel makes up part of the Sheraton hotel system".

Article 9 stated that "the operator will supply all the benefits of the Sheraton System of Reservation and Credit Cards to the hotel and its guests as well as any system of central accounting and other benefits that the Sheraton Group usually supplies to its hotels".

Article 19 stated that:

> during the operational period of this agreement the hotel will be known as 'Madeira Sheraton' or any other name chosen by the operator, but always subject to the approval of the owner. During the operational period the owner will not make use of the word 'Sheraton' unless in connection with the hotel itself. When the agreement is terminated that part of the name not containing the word 'Sheraton' and the right to use that part of the name will remain as the exclusive property of the owner. However, neither the present owner or any future owner or operator of the hotel will have the right to use the word Sheraton or any other symbol relating to the development of the hotel.

An agreement of 7 April 1981 amended Article 12 of the above contract which read as follows:

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1. These decisions were published in *Acordãos Doutrinais* 358 and 448, at 1134 and 503, respectively.
2. *Contribuição Industrial,* formerly levied on business profits.

In each tax period beginning in 1977, until the end of the initial period of operation, the operator's basic commission and the incentive commission set out in Article 12 will be modified as follows:

(a) a basic commission (0%) of the operation's annual turnover as defined in Article 12 (this rate was 5%);
(b) an incentive commission of 20% of the annual gross profits of the operation as defined in Article 13 (this rate was 15%).[3]

Following a tax audit, the plaintiff was notified that the incentive commission was characterized as a royalty for tax purposes; consequently, the tax authorities did not allow the deduction of 20% as expenses, but only accepted a 3% deduction pursuant to an administrative ruling that limited the deductibility of royalties to 3% of the total amount received by the plaintiff as services rendered in each year.

## Decision of 28 October 1998

The plaintiff signed a contract with the SOMC under which the SOMC was given the absolute control and complete authority for the operation, direction and supervision of the hotel.

In accordance with Article 12 of this contract, during each tax period, the owner was to pay the operator a consideration for the services rendered:

- a basic commission of 5% of the operation's gross turnover as defined in Article 13;
- an incentive commission of 10% of the operation's net profit as defined in Article 13.

The plaintiff booked the amounts paid as tax expenses and the tax authorities recharacterized the fees as royalties and reduced the deductible expenses to 3% of the service fees income received by the plaintiff in each year.[4]

The tax authorities made the assessment based on Article 51-A Industrial Tax Code (CCI) and Ruling 29/82.

## THE LAW

Portugal applied a schedular tax system under which income from different sources was taxed separately (i.e. under a different schedule). The schedular taxes were supplemented by a surtax (*Imposto Complementar*) which was imposed on the total amount of income of the corporate or individual taxpayer.

Profits were therefore subject to the industrial tax and during the period 1986-1987 to an additional extraordinary tax on profits and finally to a supplementary surtax.

Under Article 26 CCI only those expenses deemed to maintain the source of income could qualify as deductible expenses for tax purposes.

The distinction between services and royalties was not made for industrial tax purposes. However, the term "royalty" was defined in the former investment income tax code[5] as follows:

> payments of any kind received as consideration for the use of, or the right to use, a copyright of literary, artistic or scientific work including cinematographic films, a patent, trade work, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.[6]

Administrative Ruling 29/82 provided, among other things, safe harbour clauses for royalties, i.e. indicated the limit of royalties that a taxpayer could book as deductible business expenses for tax purposes depending on the type of activity. For hotel activities the deduction was limited to 3% of the gross fees for the services rendered by the taxpayer.

Moreover, in cases where the tax authorities infiltrated the "closed world" of associated enterprises and discovered non-arm's length prices, they could adjust the taxpayers' taxable income, determining the profit that would have been made under arm's length conditions.[7] However, the burden of proof lies on the tax authorities to show that a special relationship exists between the contracting parties and that based on such facts the conditions agreed were different from those that would be normally agreed by independent parties.

3. The tax authorities added the following amounts to the plaintiff's taxable income: 1982 – PTE 8,642,715; 1983 – PTE 17,311,080: 1984 – PTE 21,476,735 and 1985 – PTE 13,313,046. Following this, the tax authorities levied the industrial tax, extraordinary tax levied in those years and a compensatory interest charge due to the delay in the tax assessment for reasons attributable to the taxpayer.

4. For 1986, the tax authorities increased the taxpayer taxable profit to PTE 27,233,468 concerning royalties and justified the decision in the following way:

- the taxpayer treated as a deductible expense royalty payments amounting to PTE 62,128,081 which exceeded the limits under Administrative Ruling 29/82;
- in accordance with Appendix I to this Ruling the maximum deduction was limited to 3% of the value of the services rendered and therefore the limit would be PTE 34,904,613 (3% of PTE 1,163,487,084);
- thus, the tax authorities treated the excess amount of PTE 27,223,468 (PTE 62,128,081 – 34,904,613) as a non-deductible expense.

In 1987 the tax authorities followed the same reasoning and disallowed the deduction of PTE 64,312,017 as an expense.

The amounts considered to be an excess payment were added to the taxpayer's taxable profit and subjected accordingly to industrial tax, an extraordinary tax and the pertinent compensatory interest charge.

5. *Código do Imposto de capitais* (CIC).

6. The definition of this term was based on the 1963 OECD Model Convention.

7. Art. 51-A CCI was similar to Art. 57 of the current Corporate Income Tax Code (IRC) which reads as follows:

> 1. The Directorate-General of Taxes shall make any necessary adjustments for the determination of taxable income wherever, due to special relations between the taxpayer and another person, whether or not subject to corporate income tax, conditions different from those which would normally prevail between independent parties were established contributing to an accounting profit different from that which would have been made in the absence of such relations.
> 2. The provisions of the preceding paragraph shall also be observed wherever the profit, calculated in accordance with the accounts of entities having their head offices or effective place of management outside Portuguese territory, differs from that which would be calculated if it were treated as a separate and distinct entity exercising identical or similar activities in identical or similar conditions acting with total independence.
> 3. The provisions of paragraph 1 shall also be applied in relation to persons who carry on simultaneously activities subject and not subject to the general regime of corporate income tax, where identical deviations between them are detected.
> 4. Where the provisions of paragraph 1 are applied in relation to a corporate taxpayer by reason of special relations with another corporate taxpayer or person subject to the Individual Income Tax (IRS), in determining the taxable profit of the first-mentioned taxpayer there shall be made such adjustments as are necessary to reflect the effect of the adjustments made to the taxable profit of the first party.

The main difference introduced by the IRC Code was the possible adjustment foreseen under 4.

Royalties were subject to a 15% withholding tax. In contrast, following a long tradition existing in Portugal, services paid to non-resident companies directly (i.e. not through a permanent establishment (PE) in Portugal) were not subject to tax in Portugal, but only in the state of the recipient's residence.[8]

## THE ARGUMENTS

The main arguments presented by the parties were similar in both Court cases. Thus, for the purposes of this case note, they are presented together.

### The arguments of the plaintiff

The measures taken by the tax authorities to adjust the taxable income concerning the industrial tax had insufficient grounds, because they only invoked the applicability of Article 51-A CCI and Ruling 29/82.[9]

Article 51-A CCI only permits the adjustment of tax costs when a special relationship exists between the contracting parties provided the agreed conditions were different from those that would be normally agreed between independent entities. Sufficient grounds for the tax authorities' decision would therefore require that a special relationship between the plaintiff and the SOMC could be substantiated as well as that different conditions be established between the parties.

In the absence of the above, the actions of the tax authorities were not in compliance with the normal procedure for such decisions.

The amounts paid by the plaintiff should not be characterized as royalties, because the SOMC did not provide any technical information nor licensed intellectual or industrial property rights. In effect, the agreement should be regarded as a contractual arrangement to develop a hotel business. Even if the contractual arrangement could be regarded as a mixed agreement (involving service fees and an element of royalties), for tax purposes the characterization of the payments would have to follow the dominant element which was the fee paid for the development of the hotel business.

In the cases regarding the industrial tax of 1982 to 1984 the plaintiff also argued that the payments made to the SOMC did not reach 20% of the hotel's turnover, but a much lower amount, particularly because they were based on the 20% gross profit.

The payments made to Sheraton were characterized as necessary to maintain the results of those tax periods and they remunerated the management and administration of the hotel, the marketing operations and the sale of rooms in Portugal and abroad and, to a small extent, they also paid for the transfer of technology and the authorization to use the name and symbol of Sheraton. Thus, those payments by far exceeded the scope of royalties.

The assessments made by the tax authorities appeared to be, in other words, true penalties and they led to double taxation. The amount paid to the SOMC was taxed in Portugal in the plaintiff's hands, because the payments were disallowed as deductible expense, and also at the SMOC level abroad as income.

### The arguments of the tax authorities

The amounts disallowed as deductible expense for industrial tax purposes were true royalties which within the reasonable limits indicated in Ruling 29/82 could not be accepted.

## THE DECISIONS

### Decision of 20 February 1991

The STA confirmed in plenary session the view adopted by its lowest section, and stated the following:

(1) it is possible to apply Ruling 29/82 together with Article 26 CCI:
   (i) the tax authorities based their decision solely on Article 26 CCI;
   (ii) they could not have invoked Article 51-A CCI because no special relationship existed between the plaintiff and the "SOMC";
   (iii) the only relationship existing between the plaintiff and the SOMC was a contractual relationship entered into between independent parties; and

(2) the taxpayer did not shift the burden of proof:
   (i) part of the payment by the plaintiff to the operator corresponds to royalties, i.e. it was remuneration for the know-how and expertise of the Sheraton group; and
   (ii) the plaintiff did not distinguish royalties from the other payments made to the SMOC.

Thus, taking into consideration that no proof was provided and that the taxpayer's deficiencies could have a negative impact on state revenues, the tax authorities' assessment had to prevail.

### Decision of 28 October 1998

The STA found that the decision of the tax authorities was based on sufficient grounds because it treated the payments as royalties and demonstrated that a part of them exceeded the limits considered reasonable, as indicated in Administrative Ruling 29/82. This meant that the authorities had grounds for their reasoning.

However, following an in-depth analysis of the characterization of the payments as royalties, the STA held that those payments could *not* be treated as royalties because of the fact that they constituted fees for a service relating to a special agreement for the management and development of the hotel.

8. This tax treatment was changed in 1998 by Decree-Law 25/98 of 10 February 1998. At present, services paid by Portuguese residents or non-residents with a PE in Portugal are subject to withholding tax, unless a tax treaty provides otherwise – see Francisco de Sousa da Câmara, *Tax Notes International*, 9 December 1996, at 1919 and 4 May 1998, at 1407.

9. In the first appeal (the one that led to the 1991 decision) the tax authorities did not base their adjustments on Art. 51-A but only on Art. 26 CCI.

## COMMENTS

Franchising, assignment of business or management and service agreement?

It is rather unusual to have such different decisions at the highest court, particularly when very similar facts were under consideration.

The description by the STA of the agreement entered into by the owner of the hotel (the plaintiff) and the SMOC (the operator) was much more explicit in 1991 than in 1998. However, the latter judgment represents a more accurate appraisal and characterization of the agreement. While in 1991 the decision was based on the assumption that the payments included a royalties component, in 1998 the Court expressly characterizes the agreement as a special type of service arrangement.

The characterization of the agreement itself was quite complex: it was neither a franchising arrangement nor a type of lease agreement. It was not a franchising arrangement mainly because the SMOC was to manage and develop the hotel itself. Sheraton did not grant the plaintiff the privilege of using the Sheraton manual in order to allow the plaintiff to sell a service in accordance with Sheraton methods and procedures. In fact, the position of managing and developing the hotel business was attributed solely to the SMOC, where executive and operational tasks involved the assignment of the business to the SMOC, but the plaintiff continued booking all profits and expenses including the commission-related payments to the SMOC (which depended on the operation's turnover) as well as the gross profits of the operation. Thus, this agreement could not simply be characterized as an assignment of business either.

Secondly, Sheraton never transferred any expertise or other intellectual or industrial property to the plaintiff. Even the Sheraton name came with the services rendered by the SMOC and it was not possible to make a direct appraisal of such value in order to distinguish between the payments by the plaintiff for royalties and services. The plaintiff was not paying for the use of the Sheraton name. It was the Sheraton Group itself that was managing and operating the hotel, which involved the use of the name Sheraton and its own know-how. The services supplied by the SMOC under the agreement did not serve predominantly to transfer know-how to the plaintiff. The STA in 1991 refused to accept that the agreement should be characterized by the main operational services, making all the other services ancillary and subordinated to them, and not the other way round in favour of the *in dubio pro fisco* principle.

### Other considerations

Surprisingly, these decisions did not invoke the applicability or inapplicability of tax treaty provisions. Such considerations could have been relevant for characterizing the relevant transactions as well as for determining the state where tax should have been imposed. The tax deductibility of those payments could constitute one of the sides of the coin. Considerations relating to withholding tax rates would also have been decisive. Besides, it would have been interesting to consider whether or not the SMOC had a PE in Portugal, taking into consideration that a positive answer would imply a completely different approach for corporate income tax and value added tax purposes.

### The current tax law situation

Should a similar situation arise to be decided under the current tax law, the following three considerations should be emphasized:

(1) the interpretation of the agreement solely in accordance with domestic law would only be valid in the absence of a tax treaty;

(2) non-resident entities managing and performing these types of activities could be regarded as having a PE in Portugal; and

(3) the burden of proof lies with the person who intends to exercise its right. Under an additional tax assessment case, all the elements of the tax must be proven by the tax authorities unless an exception applies (e.g. taxation in accordance with an indirect method of assessment where it is sufficient to prove that it is possible to apply such methods). When a reasonable doubt exists as to either the validity of the imposition of tax or its calculation, the tax assessment should be declared null and void in accordance with Article 100 of the Administrative and Judicial Procedure Tax Code (CPPT) applicable from 1 January 2000.[10] In this scenario, it should not be possible to find that a small component of the payment involves the remuneration for intellectual or industrial property rights in order to conclude that all the payment is to be taxed as royalties. The principle of *in dubio contra fiscum* should always prevail over a hypothetical assessment, unless it is considered that the burden of proof was illegitimately shifted to the tax authorities.[11]

Although the present CPPT rules seem to leave little doubt regarding the ultimate decision to be adopted by the tax authorities, experience in practice shows that multinationals minimize risks as long as they distinguish between the different type of elements of a mixed contract or when they clarify and characterize the agreement also with respect to payments, although the latter characterization is not binding on the tax authorities or courts. Such an option would at least oblige the tax authorities to substantiate the disputed facts and provide sufficient grounds for the decision.[12]

10. The former CPT (implemented by Decree-Law 154/91 of 23 April 1991, as amended) was revoked by the new CPPT (implemented by Decree-Law 433/99 of 26 October 1999).

11. See the STA's decision in Case 23,351 (April 1999).

12. However, Case 13,405 of 8 July 1998 (the "Four Seasons Country Club") is also a good example of where the characterization of facts by the taxpayer is not binding on the authorities and is insufficient, namely when the authorities or the Court demonstrate that the characterization was used principally for tax avoidance purposes.