taxanalysts
Respectfully disagreeable since 1970.

tax notes international

Portuguese Tax Court: Payments for Engineering Services Are Not Subject to Withholding Tax

by Francisco de Sousa da Camara

The Tax Court of Lisbon ruled in February that payments made for engineering services should be characterized as fees, rather than royalties, for Portuguese withholding tax purposes.

Characterizing such payments has been a long-standing problem for many national tax administrations. Portuguese tax authorities have tended to classify payments made for engineering services as royalties. Royalties have been subject to withholding tax since even before 1998, when the Portuguese corporate income tax code first began to impose withholding taxes on fees for services rendered by nonresident entities without a permanent establishment in Portugal.

Since the 1960s, Portugal has based its international tax policy on the perception that its economy is a net importer of capital and has tended to impose high withholding taxes on dividends, interest, and royalties. The "force of attraction principle" — concerning the tax imposed on the income earned by, and property held by, foreign head offices of PEs, and by PEs themselves — was applied later, so the country has generally tried to increase revenues — or not to lose revenues — by characterizing payments as royalties.

The Issue

Commentator Michael Krause once discussed differentiating between fees paid for technical services from know-how, and fees paid for royalties.[1] Commentator Karl Sonntag recently approached the problem in a new way by defining the term "engineering" and by distinguishing engineering from related services.[2] "As there is no generally recognized definition of the term 'engineering,'" he has said, "likewise no commonly accepted description of its sub-elements exists. The borders between them are indistinct, and gray areas occur. In a simplified way it can be stated that:

- basic engineering is the technical documentation (drawings, verbal descriptions, technical data, diagrams, etc.) showing the general layout (design) of the plant in question; whereas
- detail engineering is the graphic, verbal, and numerical description of each detail."

Sonntag adds that regardless "of its breakdown into different elements, as a rule, engineering serves the purpose of planning, building, and handing over

[1]Michael Krause, "Tax Treatment of the Provision of Technical Services, International Taxation of Services," proceedings of a seminar held in Rio de Janeiro in 1989, during the 43rd Congress of the IFA.

[2]Karl Sonntag, "The Tax Treatment of Engineering in International Large-Project Contracting," 25 *Intertax* 1, 9-12 (1997).

the plant. Hence, for tax purposes there is no need to differentiate between its individual elements."

Referring to paragraph 11 of the commentary to article 12 (on royalties) of the OECD model treaty, Sonntag explained that "an element of know-how transfer from contractor to customer also takes place at the same time. This is, however, either a side effect that cannot be avoided (hence, not part of the performance agreed upon in the contract), or operational know-how (it is self-evident that the buyer of [an] industrial plant must be instructed how to use it)." As a result, Sonntag concludes that "engineering falls into the category of technical services [while] profits derived from it are only taxable in the contractor's state of residence."

Portugal's courts have addressed several international tax disputes involving engineering fees. Most have revolved around issues of associated enterprises (article 9 of the OECD model convention and the Portuguese equivalent provision — article 57 of the corporate income tax code), rather than issues of characterization (the applicability of articles 7 (business profits) and 12 (royalties) of the OECD model convention).

Lisbon Decision

In the February Lisbon decision, a multinational company had its head office and its effective management in Switzerland. The company also had a PE in Portugal that sold and distributed industrial products, mainly chemicals. The multinational group purchased a Portuguese company that dealt with chemicals, and it signed a concession agreement to explore the purchase of other Portuguese companies in complementary areas.

In the early 1990s, the Portuguese branch of the multinational constructed a new factory to produce chemicals. Under the terms of the project, the branch signed several agreements to obtain services, including engineering services, from nonresident entities that had no PE in Portugal. At the same time, to obtain a license the branch paid fees and royalties to a nonresident entity without a PE in Portugal. The entities didn't withhold tax from any of the payments.

The branch was active for three years. At the end of that period, the tax authorities audited it and concluded that all payments to nonresidents were royalties. The authorities assessed the branch withholding tax at 15 percent of the total amount paid to nonresident entities. The assessment was based on article 6(m) of the individual income tax code (on the characterization of income) and article 4, numbers 2 and 3(c), of the corporate income tax code.

The assessment didn't distinguish between payments made for the license, engineering services, remaining services, or expenses. The assessment for unpaid withholding tax used the domestic tax rate, rather than the applicable bilateral treaty rate, following the established rule that treaties aren't recognized if the parties don't complete the necessary documentation (which is necessarily the case with conflicts of qualification).

In court, it was noted that the assessments were based on a tax report that didn't refer in detail to the agreements and contracts signed by the branch, which meant classification of the payments as royalties was unsubstantiated. The branch relied on the inconsistencies regarding the agreements and argued that treaty provisions wouldn't be applicable.

The court concluded that payments made under the agreements, invoices, and services couldn't be classified as royalties. Witness testimony helped prove it was proper to characterize the vast majority of payments as fees. The expenses and the payments for the license were considered as a reimbursement of expenses and as royalties, respectively. The court found that the engineering payments were fees for services rendered by a nonresident company, and it clarified that the services were auxiliary to the construction (factory) contract. The court's analysis of each clause of the agreements was pivotal.

Concluding Remarks

A puzzling aspect of the case is the tax authorities' failure to investigate their assumption that the contractor (the nonresident company that supervised much of the factory construction and rendered the engineering services) had a PE in Portugal during the construction. If the authorities had investigated, all relevant income in the PE's hands would have been subject to tax in Portugal.

It is possible that the authorities attempted to identify a person responsible for the tax payments in Portuguese territory, because the nonresident was no longer operating in Portugal when the audit was concluded. However, the court's decision didn't address that possibility.

The case is important because it centers on the persuasive and thorny issue of royalties-versus-fees and establishes an interesting precedent for future cases. Above all, it shows that when a conflict arises over the classification of a payment, the quality of the agreements, the documentation presented, and the consistency of arguments will all influence a court's decision. ◆

♦ *Francisco de Sousa da Camara is with Morais Leitao & J. Galvao Teles & Associados in Lisbon.*