

Portugal

Appeals Court Upholds Deductibility of Royalty Payments, Citing Tax Authorities' Failure to Prove Non-compliance With Arm's Length Principle

31 March 2023

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The Portuguese Southern Administrative Appeals Court (*Tribunal Central Administrativo Sul*) decided in favour of the taxpayer (a leading multinational food and drink processing conglomerate – *Nestle Portugal S.A.*) that the formula applied to determine the amount of royalty payments by the taxpayer was in accordance with the arm's length principle, on the grounds that the reasoning and burden of proof obligations provided by the tax authorities were not fully observed.

The case referred to an amount of EUR 780,000 of license fees that the taxpayer, a Portuguese entity, paid to an associated enterprise belonging to its parent group entity. The payment of the fees was based on an agreement that stipulated a mechanism of calculation of royalty payments.

In broad terms, the contract set a specific formula for the calculation of a 5% royalty, based on the net sales income (gross sales minus certain rebates (fixed or varied)).

The tax authorities objected to the formula used by the taxpayer and made an adjustment whereby certain rebates should not have been excluded, thus increasing the sales volume. Moreover, the tax authorities considered that the agreement was a deviation from market standards.

The taxpayer, on the other hand, argued that the excluded rebate items were factors relevant for its local marketing only (and hence excluded from the control of the parent company) that should be excluded from the royalty calculation.

Furthermore, the taxpayer considered that the tax authorities didn't specify the method and operation they used to evaluate whether the conditions of the license agreement were in line with the transfer pricing regulations and, most notably, the arms'-length principle.

Accordingly, the Court held that the burden of proof of the existence of special relations lays on the tax authorities, i.e., the authorities must demonstrate clearly and effectively that the conditions of the transaction were not like the ones that would apply in a transaction between independent parties.

The decision of the Court followed the reasoning presented by the taxpayer and held that a violation of the arm's-length principle must be proven by the Tax Authorities under article 77(3) of the General Tax Procedure Act (*Lei Geral Tributária*).

The Court enunciated that under article 77(3) of the General Tax Procedure Act, the decisions must have a thorough description of the facts, laws and regulations that led to its conclusions. Specifically for transfer pricing provisions, the decision must contain:

- (i) the description of the special relations;
- (ii) the indication of the obligations that were not complied with by the taxpayer; and
- (iii) a description of the methods that should have been applied, together with the quantification of such effects.

This decision is expected to set a standard and have an impact in future assessments or corrections by the Portuguese Tax Authorities.

The full text of Decision 762/09.0BESNT, dated 2 March 2023 (but published recently) is available [here](#) (in Portuguese only).

Portugal - Appeals Court Upholds Deductibility of Royalty Payments, Citing Tax Authorities' Failure to Prove Non-compliance With Arm's Length Principle (31 Mar. 2023), News IBFD.

Exported / Printed on 7 Mar. 2024 by hkermadi@deloitte.lu.