

DOMESTIC & CROSS BORDER TAX REPORT 2008: TAX GETS TOUGH

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Authorities placing increasing importance on business structures

Iberian Lawyer's Annual Tax Special Report reveals that tax regulation, inspection and assessment across the Peninsula is undergoing great change, not only is it becoming more complex, lawyers say, it is also more effective.

Spain and Portugal have both seen significant legislative change over the past year, intending to bring domestic tax regimes further in line with European Union (EU) and other international tax regulation and best practice. The changes encompass the transition of new accountancy rules, the introduction of more severe transfer pricing requirements, and the impact of European Commission (EC) and European Court of Justice (ECJ) rulings on tax legislation.

The result, say lawyers, is that tax practices see both challenges and opportunities not only in keeping up-to-date with the pace and breadth of changing regulation, particularly as clients expand

internationally, but also to offer the requisite certainty required by them to undertake transactions.

All of this in the face of a toughening attitude amongst the tax authorities, notably in Portugal says Diogo Ortigão Ramos at Gonçalves Pereira, Castelo Branco, where there are new anti-abusive tax planning regulations, and where the authorities continue to adopt an aggressive stance to further counter a budget deficit.

"The perspective adopted by the Government of tax planning as 'immoral' stems from the preamble of the law imposing tax planning disclosure obligations and indicates that taxpayers may expect increased pressure and litigation," says Rui Camacho Palma at Linklaters in Lisbon.

New transfer rules

Clearly among the most significant current tax issues, say lawyers across both Spain and Portugal, is the introduction and impact of new rules on transfer pricing control and compliance and the associated new documentation and reporting obligations.

"New transfer pricing regulations that entered into force in Spain on 1 January 2007 established the obligation to apply the fair market value to related party transactions. This is in line with new accounting rules that require valuation at arm's length and the reclassification of any difference between the price agreed by the parties and the fair market value according to the real and effective nature of the transaction," explains Rafael Fuster, Head of Tax at Uría Menéndez.

✖ Nonetheless significant practical aspects of the rules remain pending. "Unfortunately the relevant Royal Decree, which includes specific details on the relevant transfer pricing documentation, is still under preparation by the Ministry of Finance," says Alberto Moya at Cuatrecasas.

El informe anual 2008 sobre fiscalidad de Iberian Lawyer concluye con la apreciación del enorme cambio acaecido en las autoridades regulatorias y de inspección fiscal en la Península Ibérica. La normativa fiscal es cada vez más compleja, afirman los abogados expertos, y la inspección, más hostil. También hay que destacar en la Península Ibérica el impacto de la normativa relativa a transferencia de precios y la jurisprudencia en el marco europeo relativa a fiscalidad. Abogados fiscalistas apuntan que hay grandes retos pero también oportunidades en perspectiva, no sólo en cuanto a la continua actualización necesaria y requerida por tantos cambios, sino también para con la búsqueda de soluciones apropiadas a cada operación y que se ciñan a la normativa.

For the time being therefore uncertainty continues to surround specific actions and in the design and implementation of transfer pricing policies, say many. "The new transfer pricing framework already constitutes one of the most significant developments that the Spanish tax environment has recently seen and the issuance of the long-expected transfer pricing regulations will crystallise this," suggests Federico Linares at Ernst & Young.

Firms therefore predict high demand for both documentation and strategy advice, says Juan Ramón Ramos at Landwell. Others also highlight the tax implications arising from restructuring operations as a result of the prevailing international economical situation.

The combined impact of the new regime requires a change in the mentality and processes of multinational organisations, says Javier Morera at Rodes & Sala.

Transfer pricing is inevitably a live issue in Portugal where the regulation is more advanced, say lawyers there. Nonetheless expectations surround the impact of the implementation of the new Advance Pricing Arrangements (APA) regime introduced on January 1, 2008.

The rules foresee the possibility of APAs between taxpayers, associated companies (whether Portuguese or resident in a country with a relevant Double Taxation Agreement), the Portuguese tax administration and foreign tax administrations, enabling those involved to arrange in advance the

transfer pricing applicable over a period of time.

"The ability to approach the Portuguese administration with a well structured APA request, and the capability of successfully going through an APA negotiation are, in our view, one of the biggest challenges facing clients over the coming year," says Joana Pizarro Bravo at Barrocas Sarmento Neves. Portugal is however also waiting on Ministerial orders detailing the conditions necessary for the issuance of an APA request.

Lawyers nonetheless predict that the outcome will be to reduce the potential for costly and time-consuming tax inspections and litigation. "The proposed new regime on previous agreements on transfer pricing issues which is now under discussion, will likewise bring more certainty and consistency to the existing legal framework," believes António Moura at ABBC.

Francisco de Sousa da Câmara at Morais Leitão Galvão Teles Soares da Silva & Associados (MLGTS) however questions the practical day-to-day impact of the new rules.

"Transfer pricing adjustments have not been a major problem in Portugal in recent years and unless companies feel they will be better protected, which will certainly not be guaranteed when such a procedure is initiated, they may be somewhat reluctant to take such a route."

It will however be important to assess the government's ability to present a balanced proposal, and to stabilise potential controversies, he suggests.

Offshore attraction

The "offshore" world is one that remains contentious among Iberia's tax lawyers.

Although some see an increasing sophistication among clients as to the benefits of specific jurisdictions, notably in the banking and finance arena, others nonetheless see only risk and transparency issues.

"Links with other jurisdictions, irrespective of their tax haven status, are always important in this global world," says Carlos Albiñana at Allen & Overy.

"Clients appreciate the flexibility of the law and the reduced tax cost that such territories call for when establishing, operating and liquidating structures. However, many are also increasingly concerned about the application of reporting requirements arising from money laundering and tax regulation for investments in tax havens," says Eduardo Gracia at Ashurst in Madrid.

The presence of a jurisdiction on the domestic tax authorities' "black lists" remains a strong disincentive for companies to do business there, say some.

"Stringent Controlled Foreign Corporation (CFC) rules, a very wide black list and an increasing focus by the tax authorities on transactions involving offshore jurisdictions has down-played the use of these type of structures," says Fernando Castro Silva at Garrigues in Lisbon.

In addition, certain jurisdictions are becoming less attractive as clients increasingly perceive that reputational dangers may outweigh any, potentially short-term, financial benefits, suggests Filipe Romão at Uría Menéndez in Lisbon.

Many lawyers emphasise therefore the distinctions that exist between even Iberia's own "offshore" centres – Madeira, Andorra and Gibraltar. "There are not very many law firm links with these jurisdictions. Particularly with Andorra and Gibraltar, as they are both black-listed," says Pablo Alarcón at Gómez-Acebo & Pombo. "In fact, the increasingly strict anti-money laundering rules make it more difficult to work with them."

Portuguese lawyers emphasise as a major distinction the legal and regulatory position of Madeira to

the mainland. That the European Commission (EC) has given legitimacy to Madeira's applicable corporate tax regime, which will see the gradual introduction of a 5% rate by 2020 from the current 0% – an endorsement that Gibraltar is also similarly seeking for its tax regime through the European Court of Justice.

Notwithstanding recent high profile issues surrounding the use of offshore structures to sell financial products and equity issues by Portuguese institutions, and that Madeira offers one of the lowest VAT rates in the EU (recently reduced to 14%), a number of Lisbon-based firms have long-established Funchal offices, primarily servicing clients operating within the designated Madeira Free Trade Zone (MFTZ). Among them are, Vieira de Almeida, Abreu Advogados, KPMG, Landwell, Simmons & Simmons and Morais Leitão Galvão Teles Soares da Silva & Associados (MLGTS).

"Madeira is part of the Portuguese territory and cannot be compared as such with Andorra and Gibraltar," insists Francisco de Sousa da Câmara at MLGTS. "The tax incentives exist but they require companies to comply with several criteria and obligations and, in general, they do not cover all types of income or operations, so legal advice is crucial."

Bureaucracy and hostility

Fundamentally important to any change, says Miguel Pais de Oliveira at Raposo Bernardo & Associados, is to understand how the tax authorities will be willing to interpret and to act on the instrument – with the hostility of the domestic tax authorities highlighted by lawyers across Portugal and Spain as a recurring issue.

"As the Spanish real estate business is slowing down significantly, the different regions and town halls will see now their tax collections dramatically decrease. This is likely to increase their already quite high level of aggressiveness," suggests Javier Fernández Cuenca at Pérez-Llorca.

Such a stance has already given rise to an increase in disputes, say many. "The Spanish tax authorities and judges do not follow a fair play approach as happens in other civilised countries," says Miguel Klingenberg at Freshfields Bruckhaus Deringer.

"Spain is seeing a constant increase in litigation in the tax arena because of the restrictive position being adopted by the domestic tax authorities in the audit of operations, the criteria used, and its aggressive imposition of sanctions," agrees Imma Sallent at Jausas.

Ricardo Gómez-Barreda at Garrigues states that the issue is not however the preserve of the Spanish authorities. "It is not so much the bureaucratic nature of the processes, but that the aggressive mood of some of the most important tax agencies around the world may create serious problems to multinational companies. A balanced approach to tax planning may become a competitive weapon for some countries."

✖ Lawyers in Portugal seem to agree. "The Portuguese tax authorities urgently need to develop a modern approach to business – one where taxpayers obtain timely feedback on queries and requests put to them," says Miguel Teixeira de Abreu at Abreu Advogados. "The issuance of binding rulings on time, and the enactment of clear comprehensive internal regulations are fundamental to understand what the tax administration thinks about certain transactions."

As a result of this hostility and uncertainty more clients are now willing to enter into litigation against the administration, say lawyers. "In many cases it seems that a 'war' is being waged by the domestic authorities, which often disregard taxpayer rights," says João Marques Pinto at Serra Lopes Cortes Martins & Associados.

The root cause in Portugal, suggests Tiago Marreiros Moreira at Vieira de Almeida & Associados (VdA), is the very ambitious assessment goals established by the tax authorities, combined with the

abusive use of foreclosure processes and arrests of assets, and the authorities' new, and extremely efficient, IT systems.

"In Portugal, the trend is to simplify procedures, and to computerise as much as possible. However, it is still frequently the case that the civil servant working in front of the computer is no less inflexible than the computer itself," says Miguel Pais de Oliveira at Raposo Bernardo.

EU investigating goodwill

The ability of Spanish based corporations to offset goodwill in foreign acquisitions is a tax benefit that many have utilised in their international expansion but it is, suggest some lawyers, a benefit that is now at risk.

The European Commission (EC) is currently investigating claims that this amounts to state aid, with the potential that companies may yet be ordered to repay any "lost" tax revenue.

Many Spanish experts however see little likelihood of success. "The Spanish tax treatment of goodwill in foreign acquisitions is still a significant issue. Despite the proceedings initiated by the EC, we believe that the Spanish government has strong grounds to defend its position that goodwill depreciation is compatible with the EU regulations," says Rafael Fuster at Uría Menéndez.

Its continuation is now however reliant on the ability of the Spanish tax authorities to convince the EC that there is no infringement of EU Legislation, although in any event, some lawyers believe, that while depreciation goodwill may be an attractive tax perk it has little practical influence on companies' strategic acquisition planning.

"The M&A tax market shows a clear trend indicating that international transactions are no longer structured under acquisition tax models built in the main to benefit from the tax treatment of the financial goodwill, in particular where more powerful acquisition tax structuring alternatives are available," says Federico Linares, Ernst & Young.

That the benefit is being challenged has diminished its value, say some. "Today it is seen as a benefit 'at risk' and therefore it is not that clear if it should be included in the valuation formula for future acquisitions," says Pablo Alarcón at Gómez-Acebo & Pombo. "In fact, until a final decision is adopted by the European authorities, the benefit has lost a significant part of its leverage effect."

Some even suggest that clients are already hedging themselves against any possible revocation. "I do not believe that Spanish companies are still computing this tax benefit in to their financial projections for foreign acquisitions, as the EC challenge has been quite strong," says Javier Fernández Cuenca at Pérez-Llorca.

Others however see goodwill depreciation continuing to present new opportunities. "It remains very important and as a driver for Portuguese companies to acquire businesses through Spanish structures," says Miguel Teixeira de Abreu at Abreu Advogados.



Challenges

When it comes to the challenges that such developments present law firms, there is almost unanimous agreement that a key demand, and perhaps also a differentiator, is the ability of tax lawyers to keep up-to-date with the breadth of constantly changing domestic and international regulation.

In recent years, Spanish tax legislation has seen significant amendments with respect to personal

taxation, the establishment of new anti-fraud clauses, the enactment of new accounting regulations and the control of real estate transactions, notes Rafael Fuster Tozer at Uría Menéndez. "Making sure that all members in a tax practice keep technically abreast of these changes is certainly a challenge that management must face."

"Keeping on top of domestic changes to tax regulation is mandatory and a key distinguishing factor among law firms may be the knowledge of cross-border changes and the capacity to anticipate such modifications in your own jurisdiction," suggests Nuno Azevedo Neves at ABBC in Lisbon. Others however put their faith in technology. "This is not a challenge at our firm as we have access to most of the tax databases available and operate a fantastic knowledge management system," states Miguel Teixeira de Abreu.

It is a similar story at PLMJ, says Rogério Fernandes Ferreira, "In order to offer state of the art tax advice we need to invest in resources."

Certainty

But constant change also brings issues around risk assessment and certainty, say lawyers, as does the increasing need for transparency in international tax rules (for example, the Financial Accounting Standards Board rules). "Domestic tax law and regulations are changing all the time and the difficulty is not so much keeping up to date but to ensure that the advice you give today will also be valid in the near future," says Isabel Garcia at Serra Lopes.

"The application of anti-avoidance rules by the Spanish tax authorities and the Courts is becoming increasingly regular; and this is one of the reasons why it is essential to provide the client with an accurate risk assessment," agrees Alvaro De la Via at Araoz & Rueda in Madrid.

But this ability is particularly challenging in an environment in which the tax authorities' own opinions are unclear and even contradictory, says Carlos Rodríguez at DLA Piper.

✖ The situation is particularly acute in relation to complex transactions, and where rulings are sometimes received after a transaction has completed, says Joana Pizarro Bravo at Barrocas Sarmiento Neves. "Law firms could be much more effective in providing certainty in tax advice if there was an efficient advance tax rulings system and transparent policy regarding previously issued information on similar transactions."

João Espanha at Espanha & Associados agrees that advisers have to proceed carefully. "The biggest problem is that when a certain issue finally gets significant court attention and relevant decisions the applicable law has already changed, sometimes more than once."

Lawyers have to be creative but always play safe, adds Paula Rosado Pereira at Simmons & Simmons. Also important is the ability of law firms to provide international expertise and comfort to clients, say lawyers.

"Cross border capabilities are a must in today's environment. The challenge from a management perspective is to ensure a level of quality by foreign counsel that is consistent with that offered on domestic matters," says Rafael Fuster Tozer at Uría Menéndez.

But while some find comfort in the strength of firms' international networks, others see a major challenge in competing with the Big 4 tax advisers, which some suggest are now looking to increase both the scope of their domestic and international offerings.

✖ "Law firms may not compete with the Big 4 tax advisers in matters of compliance but have nothing to learn from them in tax consultancy matters," believes Miguel Teixeira de Abreu at Abreu Advogados. "On the other hand, only tax lawyers can take up tax litigation matters and there the Big

4 are not at all as wellprepared."

"Specialisation is key," agrees Ricardo Gómez at Garrigues, who co-ordinates the firm's presence in the 35-member international Taxand network. The situation is perhaps more acute among small and medium-size law firms, admit some, where the emphasis should instead be on offering clear added value, suggests José María Duran at Rousand Costas Duran.

Complications

The wider economy may be slowing but Iberia's tax lawyers however see no reduction in demand for their services – either with active transactional sectors, such as energy and renewables, or among clients such as those in the finance, private equity, construction and real estate sectors, where the emphasis is increasingly towards restructuring or refinancing, or to search for greater efficiencies as cash flow and liquidity become of greater importance.

Many lawyers also predict an upturn in demand for litigation advice, to counter the aggression of the domestic authorities in their inspection and assessment activities.

"The ever-growing need to increase tax reserves to balance the Portuguese state budget is likely to continue to put added pressure on tax payers," says Paulino Brilhante Santos, head of tax at Miranda Correia Amendoeira & associados.

Law firms' ability to understand and navigate the legal regimes and specific tax regulations of their own and other jurisdictions clearly therefore represents a highly valuable resource, say lawyers. In a global market, companies will always look for new ways to improve their position.

But the sense among some across both Portugal and Spain is that the domestic tax regimes are in danger of becoming overcomplicated, while the manner in which the tax authorities handle issues and the potential for delays in decision-making, remain highly unsatisfactory.

"The very extensive body of Portuguese tax regulation is now very strict and the authorities are responding to that in what has become an almost persecutory way," says Vítor Félix at F Castelo Branco & Associados Nonetheless many see further growth in both the volume of domestic and cross-border work, as clients demand more sophisticated tax planning tools and solutions.

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"Each year our tax practice focuses more on cross-border tax simply due to the fact that the most relevant transactions have international players and because of the increasing role that EU rules, courts and jurisprudence have on domestic tax law and procedures," says Tiago Marreiros Moreira at VdA.

But while complexity may present opportunities for law firms to display their skills, continuing uncertainty around tax liabilities, many caution, does little to promote international investment, and for some clients the corresponding risks may ultimately prove intolerable.