Spanish Tax Alert

Soft-drink procurement mixed contracts deconstructed using Secret Comparables in Spain: the position of the Economic-Administrative Court

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1. Introduction.

On October 3, 2013, the Spanish Central Economic-Administrative Court (TEAC –an administrative Tax Court-) delivered its ruling on the tax assessment carried out by the Spanish Tax Authorities to a Spanish bottling/distributing company on withholding taxes for deemed royalty payments in relation to a contract of procurement of concentrates with a third party US producer of soft-drinks.

The TEAC confirms the power of the Tax Authorities to partially redetermine the allocation and characterization of a consideration –business vs. royalty income- in a contract between independent parties. Accordingly, the Tax Authorities would be able to ignore a valid civil contract for tax purposes which foresees that a good or service (e.g. license of intellectual property) is provided without any consideration where certain circumstances are met. However, the court rejected the valuation methodology used by the Tax Authorities to reallocate the income corresponding to the different services included in the contract to the extent that the use of "secret comparables" generates defenselessness to the taxpayer.

2. The Facts

The facts can be summarized as follows:

- The Spanish bottler-distributor (SpanishCo) entered into two third-party contracts; one with another Spanish entity (SpanishCo2) by means of which the former could use certain trademarks of the latter in order to process, package, distribute and sell certain products (soft drinks) identified under those trademarks within a given territorial scope; and another with a Swiss entity (SwissCo) whereby it allowed SpanishCo to use a trademark in order to process, package, distribute and sell the soft drinks identified under those trademarks within a given territorial scope.

- In both cases, the parties had expressly agreed to use the trademarks, labels, designs, containers and other intangible assets without payment of fees or royalties.

- In both cases, SpanishCo undertook to prepare the beverages using certain "concentrates" that needed to be purchased (i) in the first case, exclusively to a US group entity (USCo) to which SpanishCo2 pertained or to providers duly authorized by such entity; (ii) in the second case, to SwissCo. In both cases, these providers were exclusively the ones who fixed the prices and conditions for selling such "concentrates" to SpanishCo.

- During the course of a tax inspection to SpanishCo, the Spanish Tax Authorities considered that, according to the Spanish domestic Law, sales of goods are presumed remunerated unless evidenced to the contrary, and thus the trademarks licensing to SpanishCo was not free of charge (as the contracts established), but remunerated, being such consideration included in the price of the "concentrates". The Tax Authorities considered that such consideration should have been regarded as a royalty for the trademark licensing.

- Payments performed by SpanishCo are made to two entities with different tax residence:

  a) Payments to an offshore entity (OffshoreCo), which was a subsidiary of USCo, and had an Irish branch from which it supplied the "concentrates" to SpanishCo. Due to the residence of the recipient of the payment (offshore) the Spanish Tax Authorities considered that the double taxation agreement (DTT) between Spain and Ireland was not applicable. Consequently, the Spanish domestic withholding tax should have been applied (24-25%).

  b) Payments to SwissCo. Due to it being a Swiss resident company; the Swiss--Spanish DTT was applicable, which sets a maximum rate of withholding tax on royalties of 5%.

- As a result of the above, the tax examiners made a tax assessment to the Spanish entity for the non-application of withholding taxes to the deemed royalties derived from the transactions with OffshoreCo and SwissCo.

3. The TEAC's Ruling

The conclusions of the TEAC regarding the assessment carried out by the tax examiners can be summarized as follows:

Recharacterization of the procurement contracts

Firstly, the taxpayer objected to the tax assessment since it considered that the recharacterization of the contracts concluded by the SpanishCo with SpanishCo2 and SwissCo was unlawful, on the grounds that they did not contain a remuneration for the right to use the trademarks , but expressly establish a mere temporary permit to use such trademarks for the purposes of processing, packaging and distributing the beverages which does not result in any payment of fees or royalties. However, the TEAC confirmed the position of the tax examiners which considered that the contracts contained a trademark license. This position was grounded on the Spanish domestic provision which allows the Tax Authorities to perform a tax recharacterization regardless of the name given to a transaction by the taxpayers (general anti-abuse rules)[1].

Re-allocation of the consideration of the procurement contracts

The second issue analyzed by the TEAC is whether the licensing of the trademarks should have been, for tax purposes, remunerated or non-remunerated. Due to the transactions were carried out between unrelated parties, the tax examiners applied the presumption of remuneration contained in Spanish domestic Law. The main question was to determine the portion of the consideration paid by SpanishCo -in exchange for the purchase of the "concentrates"- that should be attributable to the use of trademarks. In this regard, it assumes that both the "concentrates" and the soft drinks made with them have a certain economic value, which increases if they are marketed under a reputed trademark. Precisely this value added

[1] The Spanish Supreme Court has recognized this power in Judgments of May 28, 1990, June 25, 2008, and January 12, 2011.

by the trademark -which allows the increase of the revenues that would result from the sale of the product itself without the trademark- is what justifies the marketing expenses incurred to maintain and/or increase the value of the brand.

Thus, both the tax examiners and the TEAC held that the consideration for the sale of "concentrates" included and concealed a remuneration for the trademark use and, by analogy with what occurs in transfer pricing, this fact would lead to apply the rules to break down and apportionment of the whole amount of the stipulated consideration according to the various parts of what is being provided under these*"complex contracts" (bundle contracts/package deals)* in order to apply to each part of it so determined the taxation treatment proper thereto[2] [3]. From a commercial point of view, SpanishCo made a substantial and continuous use of the brands in its drinks business distribution, and thus a portion of the consideration paid to the foreign entities should have been attributed to the trademark use. The tax examiners allocated very high values to the use of the trademark by the Spanish entity (between 46.18 % and 61.17 % of the price of the purchase of concentrates).

The TEAC also rejected the ancillary nature of the trademark licensing due to their high value and how they were used in the distribution phase of the final product being related not to the "concentrate" but to the final product. Therefore, it was considered that part of the price paid on the occasion of the sale of "concentrates" which exceeded the value of the "concentrates" had to be re-characterized as a royalty for the use of the trademark.

Valuation methodology used for the reallocation of the consideration

The third controversial issue reviewed by the TEAC refers to the quantification of the portion of the consideration which should be qualified as a royalty due to it being characterized as a royalty for the use of the trademark. The valuation methodology used by the tax authorities had several limitations since they were unable to get information from trademark licensing agreements with independent parties similar to the one signed by SpanishCo with the US Group nor any market comparable (although there were some independent reports which attributed to the licensed trademark a royalty equivalent to 15% of the retail sales). The following key elements were taken into account in the valuation:

a) Retail prices of drinks produced by X in terms of Euros/liter, and

b) The cost of concentrates of generic brands which were comparables in terms of Euros/liter.

Regarding the second key element, the valuation analysis reflects that the tax examiners requested certain information to two companies which undertook the activity of processing and packaging of soft and juice drinks for third parties; in particular, concerning the costs of raw beverage bases necessary to develop the different flavors of products.

From these data, the valuation methodology led to making an estimate of the royalties over the average sale prices of the products. As mentioned, the tax examiners allocated very high values to the use of the trademark by the Spanish entity (between 46.18 % and 61.17 % of price of the concentrates).

The taxpayer adamantly opposed to such valuation methodology saying basically that it was a "subjective motivation" (subjective comparable) that caused him defenselessness by not having access to data on companies that were taken as comparable by the tax examiners for the purposes of determining such valuation.

[2] Para. 6.17 the OECD Transfer Pricing Guidelines.

[3] This rule is also reflected in the comments to art.12 of the Model Convention of the OECD (para.11.6).

This lack of identification of companies was founded by the tax examiners claiming confidentiality of tax data of taxpayers.

The TEAC, after analyzing both parties' arguments, decided to rely on the OECD Guidelines on Transfer Pricing -which are contrary to the use of "secret comparables" by the Tax Authorities- since (i) this can generate defenselessness to the taxpayer and also affects the integrity, fairness and transparency of the transfer pricing regime; and (ii) the taxpayer does not have the means to test the selection procedure of the comparables and their reliability.[4 5]

Accordingly, the TEAC determined that the tax authorities had applied an inappropriate method (i.e. subjective motivation) and **decided to admit the arguments of the taxpayer and annul the valuation and the tax assessment carried out by the tax examiners.**

4. Final remarks

The doctrine established by the TEAC in this resolution has the following important implications:

1) Confirmation that the use of "secret comparables" in transfer pricing (or other) valuation procedures is heavily forfeited, since it does not grant an adequate motivation of the valuation conclusions, and thus does not allow the taxpayer to oppose to that valuation and the corresponding adjustment carried out by the Tax Authorities.

2) Despite the "soft/taxpayer friendly" position of the administrative doctrine on the use of secret comparables we cannot overlook its "hard" position by confirming the power of the Tax Authorities to recharacterize and reallocate the consideration in a contract between independent parties, allowing the Tax Authorities to ignore for tax purposes a valid civil contract that expressly states that a service is given without consideration (other fields were this doctrine could potentially apply –e.g. allocation of income/withholding taxes- are franchising contracts).

The position adopted by the TEAC should be specially taken into account when related companies carry out sales or services agreements or transactions that include an intangible asset, and not only in cases of "artificial splits" in "mixed contracts" but in any other case where the transaction includes and intangible asset or right without being provided an specific consideration for it.

4 Para.3.36 of the OECD transfer Pricing Guidelines 2010.

5 The mentioned position contrary to the use of secret comparables had already been recognized by the TEAC in its rulings of March 14, 2008 and September 5, 2009. This principle was confirmed by the High Court which went beyond the provisions of the TEAC since the High Court nullified the revaluation made in such terms for using a valuation method which was inappropriate and that caused the taxpayer defenselessness (Judgment of May 12, 2011).