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Belgium: Transfer pricing aspects of restructuring

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Multinational groups are constantly unwinding and re-assembling their value chains to safeguard their competitive edge. Some parts are outsourced while others are accommodated in-house to protect them against unwanted divulging of know-how, or to focus on other business objectives such as quality control, cost containment, workforce motivation, or other purposes.

Belgium is known as a country that rigorously follows the OECD developments with a view to apply the guidelines comprehensively and consistently regarding its guidance on transfer pricing matters. Consequently, the inflow and outflow of profits upon value chain reshuffling, causes the Belgian tax authorities to closely monitor international developments in this field, in particular in relation to Chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (transfer pricing guidelines), published on July 22 2010.

The issue is on the radar of the specialised transfer pricing investigation team, in the Belgian tax administration, and is also systematically addressed by the Service for Upfront Decisions (informally called the Ruling Commission) when a taxpayer applies for an advance pricing arrangement (APA). Both of these teams adhere to the OECD principles meaning a taxpayer can easily find out how a certain transaction will be looked at and taxed accordingly, mitigating the risk of unpleasant surprises.

Planning a restructuring

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While planning a restructuring, one should assess whether Belgian companies are subject to a change in functionality and/or risk profile that would qualify as conversion. If a conversion exists, one must carefully examine whether the conversion involves a transfer of functions, rights and/or assets containing valuable profit potential that should be remunerated at arm's-length.

According to the arm's-length principle, compensation would ordinarily be required if an independent third party acting in similar circumstances would not have entered into such conversion without proper compensation. To determine whether there is a need for compensation, one must consider all circumstances at the time of the conversion, as well as the options that were realistically available at the time. In line with the OECD transfer pricing guidelines, the Belgian tax authorities must refrain from using hindsight.

Challenges and opportunities

At first glance, the Belgian standard corporate tax rate of 33.99% does not paint a rosy picture of the benefits of shifting premium profit potential to a Belgian entrepreneur - or principal - company. From that general perspective, one would merely expect to see Belgian presences such as limited risk service providers (for example, distribution and logistics centres, shared service centres and/or contract R&D providers), low-risk manufacturers (for example, toll manufacturers or contract manufacturers) or low-risk distributors (for example, commissionaires or even agents), whereas the higher value activities reside in a tax-effective jurisdiction. However, Belgian law has provided a framework to accommodate tax-optimised, value-added business models in Belgium.

For instance, article 185(2b) of the Belgian Income Tax Code (BITC) states that Belgium will refrain from taxing profits that a Belgian company would not have realised had it not been part of related-party dealings.

The rationale here is that as the cost structure (and presumably also the profit potential, as the case may be) of a member of a multinational group of companies will normally be different from that of a standalone entity (to minimise transaction costs), its profit will normally also be higher. This profit differential, which does not result from the functions performed and risks assumed by the respective entity, should not be allotted to the Belgian group member on the basis of the arm's-length principle.

Also, the well-known system of the notional interest deduction, providing business relief for equity funding as if it were debt, has enabled multinational groups to maintain centralised activities such as internal finance centres in Belgium. As a final example, the Belgian Patent Income Deduction lowers the effective tax rate by exempting 80% of proceeds from patented technology and processes resulting in a very moderate 6.8% tax rate.

When considering a restructuring, one should bear in mind that without appropriate substantiation, generally included in robust defence documentation, the Belgian tax authorities could claim an adjustment to the taxable basis and impose tax penalties (usually ranging from 10% to 50%). In case of prior tax losses, tax authorities may claim annulment when the arm's-length nature of the transfer pricing policy before conversion or applied upon conversion itself cannot be demonstrated. This tax exposure can be mitigated when contemporaneous business conversion documentation is prepared, either for the purpose of a transfer pricing defence file or for an APA application.

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Tax authorities may also try to argue that a permanent establishment (PE) of the principal is created in the country of the limited-risk entity. This approach, however, is not frequently applied in Belgium. Indeed, a technically robust approach does not leave much room for combining a transfer pricing issue with a PE analysis. Most challenges are therefore made on the arm's-length nature of the compensation itself. However, it remains to be seen how the OECD proceedings on this topic will influence the Belgian tax authorities' approach.

Finally, one cannot overemphasise the fact that any business restructuring entailing tax consequences necessitates a healthy operational change as a starting point. Consequently, the restructured supply chain processes should carefully reflect the shift in functions, assets and risks. This means that processes such as product development, purchasing, manufacturing and distribution have to be adapted to the new business model. This adaptation will impact many aspects of the business including, among others, technology, financial reporting, and product invoicing. In most cases a centralised organisation and system of standardised processes creates the potential for significant business benefits such as reduced inventory levels, improved capacity utilisation, increased buying power, etcetera. Demonstrating these business benefits will be a winning element in the defence file.

Regulatory overview

Belgium does not have specific provisions in its income tax code dealing with value chain transformations. In an assessment of whether or not remuneration is due upon a cross-border deployment of functions, assets and risks, the OECD transfer pricing guidelines govern the Belgian legal and administrative approach. Although the OECD transfer pricing guidelines are not legally binding, they are treated as stemming from an authoritative source and provide the basis for transfer pricing policy in Belgium.

One should bear in mind that the compilation of transfer pricing documentation is not mandatory by law in Belgium. Apart from the codification of the arm's-length principle in the BITC, there are no separate documentation or penalty rules. The adherence to the arm's-length principle is confirmed through a Practice Note of 28 June 1999. The European Code of Conduct on Transfer Pricing Documentation was adopted, and its application in the field was further detailed in the practice note of November 2007. The Ruling Commission provides most of the direction in terms of transfer pricing policy. Most rulings are published on a no-name basis.

A restructuring is likely to be assessed in Belgium from the perspective of its rules and practices on artificial profit shifting. To that end, one may reasonably expect the Belgian authorities to proceed through considering the functionality and risk profiles of the parties involved from an arm's-length principle before and after the restructuring. This will enable them to see what really changed and whether or not one or more transfers have occurred that must be recognised for transfer pricing purposes.

The transfer of functions and/or risks, loss of profit-making opportunities or termination of a contractual relationship without any transfer of sufficiently identifiable assets, whether tangible or intangible, should not in itself entail the payment of compensation. A fair market price should be paid only when there is an actual transfer of property or where a converted entity does not have a commercial reason to participate in a business conversion, but agrees to do so under the express condition of an adequate compensation.

Court cases

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There are very few court cases involving litigated transfer pricing adjustments. This is merely a result of field investigations and practice, whereby most transfer pricing adjustments come in the form of a settlement reached between the tax authorities and the taxpayer at the administrative level of an investigation (before embarking upon the judicial level).

In this context, due to the absence of detailed legislative guidelines on transfer pricing, the practice note issued by the Belgian tax authorities and the unilateral APAs rendered by the Belgian Ruling Commission play an important role in shaping the Belgian transfer pricing landscape.

Ruling practice

Over the past few years, the Ruling Commission has issued several APAs dealing with both inbound and outbound reorganisations. We observe that the Belgian tax authorities tend to attach great importance to the underlying business rationale in taking such decisions. When they investigate whether consideration is due in the case of an outbound restructuring, the realistic options will be considered in order to determine whether this is a mere opportunistic act or a necessity for future success or even survival of the business. Our experience with the Ruling Commission has shown increased scrutiny regarding outbound business restructurings transferring profit potential to third countries and restructurings that entail extraordinary costs borne by the Belgian entity as a result of the restructuring process following the aftermath of the first financial crisis in 2008.

Focus of the tax authorities

The Belgian transfer pricing investigation team is very much aware of cases of business restructurings, especially when scaling-down costs are reallocated to limited-risk entities. As indicated previously, it is therefore highly advisable to prepare solid business-conversion documentation in advance for the purpose of a transfer pricing defence file, or to request an APA.

An example of a recurring issue is whether costs incurred upon conversion are to be recharged to related parties. In the authors' opinion, there is no common solution. Charging those costs to the principal entity, to the company taking over the activity (for example the production capacity) or even to the parent company (or a combination thereof) may all be realistic options, depending on the contractual arrangements and the factual circumstances. Also, the authors have experienced in a number of cases that sound arguments may exist to defend potential phase-out costs being borne by the restructured local entities, provided that the business rationale is carefully substantiated by the entities concerned, as the decisions are presumably ultimately aimed at preserving the entities' presence as a going concern.

Common practice

The issue of business restructurings is well known by the Belgian tax authorities, and it systematically triggers attention during field audits. Moreover, it is becoming more important on the agenda of the Ruling Commission, as taxpayers frequently use the opportunity to obtain upfront certainty on the topic by means of an APA.

Multinational enterprises operating in Belgium or considering moving a vast array of activities such as internal banking, intellectual property development, or entrepreneurial activities should keep in mind the opportunities Belgium offers today. Securing the relocation or conversion through an APA mitigates any

embedded tax risk and offers long-term certainty on the tax treatment of the transaction; this certainty embedded tax risk and offers long-term certainty on the tax treatment of the transaction; this certainty relates to the arm's-length nature of the conversion, the post-conversion remuneration methodology and the absence of a PE.

As to the conversion itself, it would be inaccurate to state that moving to entrepreneurial models automatically necessitates the recognition of a formal transfer of assets from a Belgian perspective. Changes in functionality and risk profile do not require the recognition of a transfer so as to meet the arm's-length standard. This means that the fact patterns may or may not mitigate the risk that a taxable capital gain occurs upon implementation of a restructuring. Attention may need to be paid to the underlying legal arrangements, in particular the notice periods laid down in contracts. These notice periods should also be in line with reasonable business practices and case law.

Finally, it is important to note that Belgium tends to adopt a reasonable approach to the issue of business transformation, in line with the OECD views. This is probably because Belgium is known as a faithful follower of the OECD's proceedings on transfer pricing, although it is also inspired by a tendency for groups to pursue both inbound and outbound restructurings in Belgium. A balanced stance is thus pivotal for the sake of consistency.

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