

Hugues Lamon
IFA Brussels 14 September 2010

Belgian report

Cross border business restructuring

September 2010

P w C

Agenda

Context

OECD guidance

Background

Key features

Challenges / Belgian principles

Inbound

Outbound

Tax effects of cross border business restructuring

Transfer of risks

Transfer of functions

Transfer of intangible assets

Transfer of going concern

Termination or substantial renegotiation of existing arrangement

Recognition of the actual transactions undertaken

Permanent establishment issues

Conclusion

Context

European context

Current economic climate

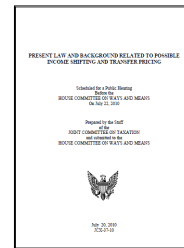
- Governments are looking to fund budget deficits
- Globalisations forces sharing of information on tax payers
- Global trade / planning – impact of technologies
- Pressure on compliance and social responsibilities
- Emphasis on substance and qualitative reporting

Belgian companies are naturally highly exposed to international trade

Transfer Pricing Unit is aware of business restructuring issues

Social measures

Implementation of the EU merger directive



Context

Business restructuring

A “business restructuring” or “conversion” refers to the cross-border redeployment by a multinational enterprise of entrepreneurial functions and risks. A business restructuring may involve cross-border transfers of key intangibles.

Examples:

- Fully-fledged distributors \Rightarrow conversion into commissionaires or limited-risk distributors operating for the principal (OECD guidance 9.10)
- Fully-fledged manufacturers \Rightarrow conversion into contract or toll manufacturers operating for the principal (OECD guidance 9.130)
- Rationalization or centralization of operations
- Transfer of IP to a principal
- Migration of intangibles to tax effective companies
- Renegotiation of contracts
- Closing down of plants
- Etc.

Background

- CTPA Roundtable in January 2005
- A joint WP1/WP6 working group set up to address transfer pricing and treaty aspects
- Publication of "Discussion Draft on Transfer Pricing aspects of Business Restructurings" on the 19th of September 2008. 4 issue notes address the impact of transfer pricing on business restructuring:
 - Special considerations relating to the allocation of risks
 - Transfer pricing treatment of the restructuring itself
 - Remuneration of post-restructuring transactions
 - Recognition of actual transactions undertaken
- Over 400 pages of comments filed after a public consultation in June 2009.
- On 22 July 2010 the OECD published final guidance on business restructurings. The guidance combines the four issues notes into a single, four-part chapter (chapter IX) of the OECD Transfer Pricing Guidelines.
- Revision of Chapter I – III of OECD Guidance : work on comparability, use of profit based methods.

Key features of new OECD guidance chapter IX: Business Restructuring

(OECD guidance as published on 22 July 2010)

1. Tax authorities should respect the taxpayer's business operational changes, as long as the changes meet the test of commercially rational behaviour (OECD guidance 9.37)
 - "Would two unrelated parties have operated in the same manner?"
 - Re-qualifying a transaction as not commercially rational only in exceptional circumstances
2. The parties need appropriate intercompany contracts to assume the risks
3. The allocation of risk is to be respected if
 - The entity has the ability to control or manage the risk
 - The financial capacity to absorb the risk
4. Profit potential is not an asset, as such, a transfer of profit potential does not require compensation under the arm's-length principle
5. One should assess the impact of an actual transfer of assets based on "the options realistically available to the parties"
6. MNC's allocate risk in a different way than third parties and there should be no presumption that contractual renegotiation or termination gives rise to compensation due

Challenges

Restructurings trigger multiple tax and legal elements

- Migration of functions, assets and risks has an impact on the profit allocation and thus the taxable basis
- One of the most complex items consists of transfer pricing
 - Example: allocation of conversion costs, proposed transfer pricing, exit tax, etc.
- Example: conversion buy-sell entity into agent
 - Creation of PE
 - Exit payment – goodwill upon conversion
 - Appropriate TP post-conversion
 - Disregarding transaction
- To date, MNC's had minimal guidance on how to manage these issues
- Some tax authorities like Germany have taken steps to define their position
- Recent release of the revised OECD guidance attempts to define these issues, and provide a consensus approach for MNC's to assess and manage transfer pricing risks associated with restructurings (see infra)

Belgian principles

Inbound

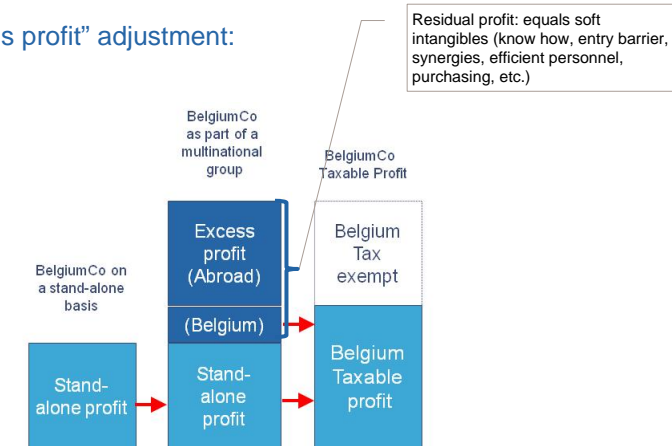
Location of a central entrepreneur, purchasing or financing structure in Belgium

Section 185 §2, b of the Belgian Income Tax Code offers the opportunity to apply a downward "excess profit" adjustment:

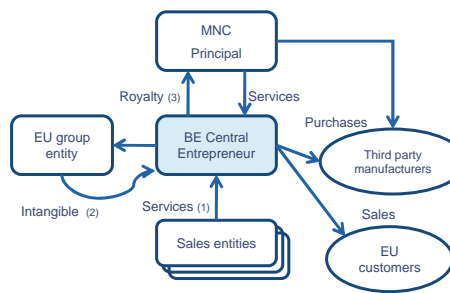
- "Notwithstanding the second part of this paragraph, in relation to 2 companies, members of a multinational group and their cross-border relations:
 - b) where in the profit of a company profit is included which is also included in the profit of another company and which consists of profit which would have accrued to that other company if the conditions agreed upon between these two companies were as between independent companies, then the profit of the first mentioned company will be adjusted appropriately."
- Opportunity should be available when:
 - Profit is allocated to Belgium, which would not have been realised on a stand-alone basis
 - Such profit is coming from cross-border transactions with entities with which some form of economic solidarity exists
- The portion of accounting profit exceeding the arm's length taxable profit should be agreed in a formal APA with the Belgian tax authorities (a so-called "excess profit ruling"). 7 rulings have been granted up to 2009.
- The downward excess profit adjustment is unilateral, the Belgian Rulings Commission does not require a tax adjustment in foreign country (PQ 13 April 2005 – Tommelein)

Belgian principles Inbound

Downward "excess profit" adjustment:



Case study Excess profit



Ruling 800.044 dd 12.08.2008

Background:

- A North-American based MNC has a European division
- The group wants to implement a "Global Entrepreneur Model" and a new transfer pricing policy

- The central entrepreneur will:
 - will be a Belgian entity
 - will perform all European strategic functions and assume all related risks
 - will pay 15% of turnover as royalty for the use of intangible assets and a buy-in royalty for the transfer of the customer lists (buy-in payment)

Taxpayer requests an APA for:

- Exemption of the excess profit of the Belgian central entrepreneur
- Tax deductibility of royalties and buy-in payments

Profit calculation:

- The residual profits derived from the fact that a MNC can operate more efficiently than the sum of its parts (synergy), integrally belongs to the party that performs the most complex tasks i.e. the central entrepreneur

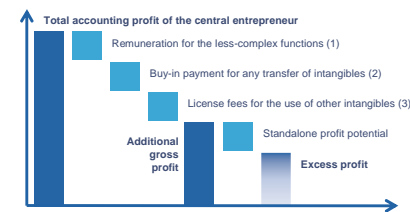
Excessive profits in the sense of art.185,§2,b equal:

- total profits of the central entrepreneur based on the residual profit approach
- minus the remuneration to the central entrepreneur based on the pure arm's length approach

This corresponds to the difference between:

- expected EBIT of the central entrepreneur for the targeted activities
- EBIT in similar circumstances, covering the same activity without being part of the group

- Determine the intra-group notional royalty in accordance with the arm's length principle via a benchmarking company



Belgian principles Outbound

(Art. 26, 185 §1 ITC)

Any received compensation is subject to 33,99% corporate income tax (exit tax)
Possible reintegration of a “deemed compensation” by the Belgian tax authorities,
taxation of non arms’ length transfer of goodwill

- Possible offset against prior tax losses carried forward
- Outbound relocation costs (Art. 26, 49 ITC)
 - Party taking decision and benefitting from relocation
 - Answer to be found in the contractual arrangements, insofar arm’s length
 - Belgian tax law adheres to the principal of “form”
- Ruling nr. 900.181 dd 28/07/2009, nr. 600.085 dd 13/04/2009, nr 900.369 dd 17/11/2009

Transfer of risks

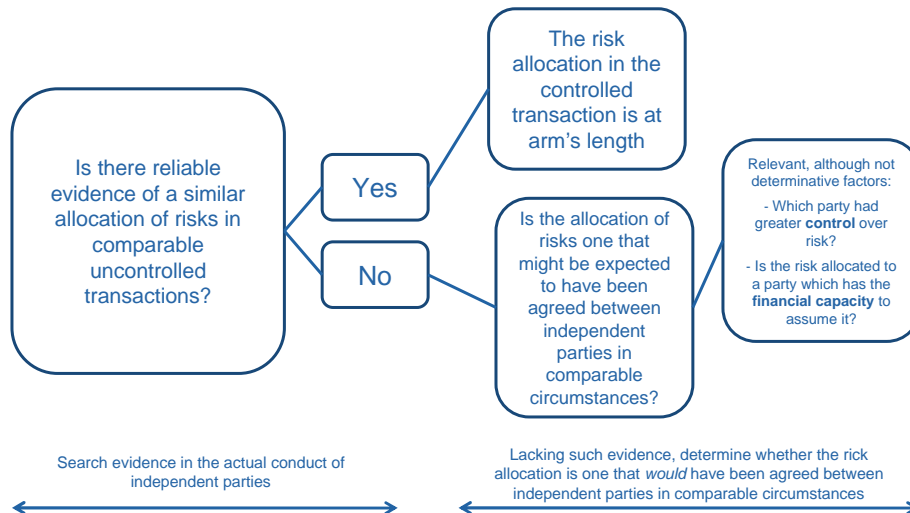
OECD guidance 1.45 , 1.64, 9.25, 9.26, 9.33

Key principles

- Risks allocation is an important element within the context of business restructurings since local operations are often converted into low risk entities
- In the open market, the assumption of increased risk should be compensated by an increase in the expected return
- Contractual arrangements are the starting point for determining which party to a transaction bears the risk associated with it
- The contractual allocation of risk is respected only if it is underpinned with economic substance. Therefore, a review of contractual terms must be completed by an analysis of following matters:
 - Does related parties conduct conform to the contractual allocation of risks
 - Do contractual terms provide for an arm’s length allocation of risks

Transfer of risks

Determining whether the allocation of risks in a controlled transaction is arm's length



Transfer of risks

Who “controls” the risk

- Risk control vs. day to day management of the risk
- A redefinition of the decision making process to ensure that the principal has the people and expertise to credibly perform the risk-control functions.
- “control over risk approach” (art. 9 OECD) vs “risk follows functions approach” (art. 7 OECD) (significant people function)

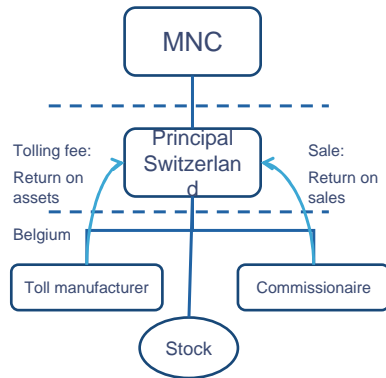
Who has the “financial capacity” to assume the risk (OECD guidance 9.25)

- The party assuming the risk should have the capacity to bear the consequences of the risk should it materialise or put in place a mechanism to cover it (e.g. by hedging it)
- Example: fund manager

Potential issues

- Can a distributor be “limited risk” if its employees manage inventory risk, collection risk and customer service?
- Can a principal company bear risks of a limited risk manufacturer (quality, defects, procurement, delivery, wastage) if employees of the limited risk manufacturer manage these risks?
- A guaranteed level of income does not in itself signify “limited risk”. A functional analysis precedes allocation of risk, and the determination of a proper TP methodology follows functions and risks.

Case study Conversion into toll manufacturer



Prior to the conversion, the toll manufacturer was a full-fledged manufacturer and the commissionaire a distributor

Ruling nr. 400.382 dd 17.02.2005

Background:

- A multinational group active in the production of consumer goods reorganised its Belgian and EU operations from fully fledged production and distribution activities into a toll-manufacturing/ commissionaire arrangement by centralizing the principal function in Switzerland.

Taxpayer requests an APA for:

- Remuneration to be applied for the toll manufacturer and commissionaire are at arm's length
- The Swiss principal has no PE in Belgium
- No taxable goodwill will arise upon conversion

Transfer pricing:

- Based on a functional and benchmarking analysis
- Return on asset/cost plus remuneration for the tolling entity
- Return on sales for the distributing company
- The restructuring cost will be charged on to the Swiss principal

Permanent establishment:

- No PE as the presence in BE is limited to the maintenance of inventory, with sole purpose of having it processed by another company.

Goodwill:

- No transfer of intellectual property

Transfer of functions

- Would a 3rd party be willing to pay for the transfer?
 - e.g. will the transfer of functions generate an expected return for the receiving entity
- Assignment of employees does not generate a transfer of intangibles
 - è So, no compensation to be paid in case of relocation of functions
- Begin by understanding the business reasons and expected benefits from for the restructuring including:
 - changes and how they have affected the functional profile of the parties
 - anticipated benefits from restructuring, including synergies
- Must consider the options realistically available to both the transferor and the transferee

Transfer of functions

- **2 elements to highlight:**

1. Profit / loss potential is not an asset, but is instead a measure of the value of other assets that may be transferred (decision 900,417 of 22 December 2009, Decision 2010,100 of 30 March 2010).
2. Relevant question: does the restructuring involve a transfer of rights or assets that carry with them a valuable profit potential* which should be remunerated at arm's length

See example in Appendix

- **Analysis requires:**

- factual identification of functions performed before and after the restructuring
- an evaluation of the rights and obligations of the restructured entity under the pre-restructuring arrangement – including provisions of such arrangements that may be implied from the conduct of the parties
- an identification of intangible assets transferred

* OECD guidance refers to a transfer of something of "value" which is quite vague and will be subject to interpretation when finalising chapter 6 on intangible property.

Transfer of intangible assets

OECD guidance: 9.65, 9.67

Key issue:

Does the transfer entail a migration of assets having specific rights stemming from law or contract?

è An acquirer only pays for an asset which is protected

- A business opportunity or transfer of profit does not constitute a protected intangible (infra)
 - E.g. human capital, market share
- A protected intangible can be valued by a DCF (discounted cash flow) analysis on the income flow
 - E.g. royalty fee's
- 3 methods as applied by the Belgian Ruling Commission (patent box)
 - Cost-plus basis
 - CUP method (comparison with third-party licences)
 - Transaction net margin and residual profit split method
- Ruling nr. 600.460 dd. 30/01/2007, 700.075 dd 10/06/2007, 800.231 dd 13/01/2009, 800.044 dd 12/08/2008, 900.377 dd 01/12/2009, 700.541 dd 04/11/2008

Transfer of going concern

OECD guidance: 9.94, 9.96, 9.99, 9.150, 9.151, 9.153, 9.168, 9.178

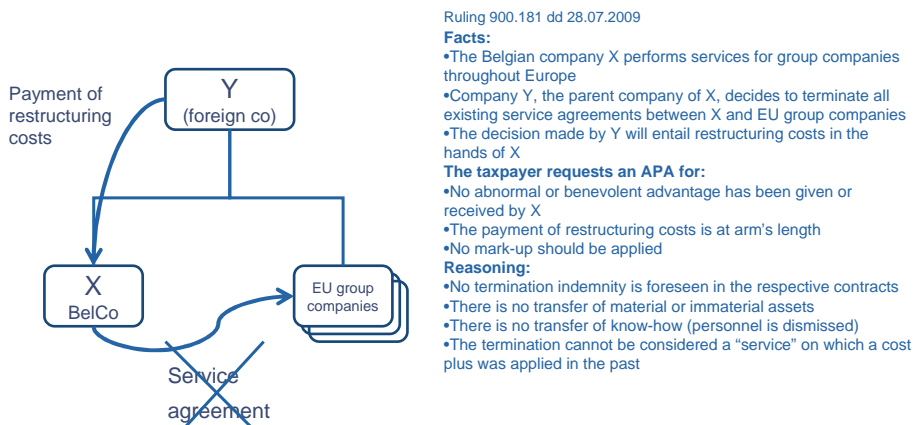
Transfer of all assets and liabilities attached to a certain activity, including the ability to operate and bear certain risks.

The value should take into account all valuable elements attached to the business

The restructuring entity can be saved from future losses

- Should the transferor compensate the transferee?
 - ↳ **Would a 3rd party be willing to pay in similar circumstances?**
- Belgian tax authorities: expense the restructuring costs without mark-up
- Location savings through lower cost base could create profitable business
- Remuneration of relocation of skilled labour through transactional profit split method
- Example
 - highly competitive manufacturing activity vs. skilled labour activity (intangible) see hereafter
 - Transfer of client base

Case study Termination of activity



Ruling 900.181 dd 28.07.2009

Facts:

- The Belgian company X performs services for group companies throughout Europe
- Company Y, the parent company of X, decides to terminate all existing service agreements between X and EU group companies
- The decision made by Y will entail restructuring costs in the hands of X

The taxpayer requests an APA for:

- No abnormal or benevolent advantage has been given or received by X
- The payment of restructuring costs is at arm's length
- No mark-up should be applied

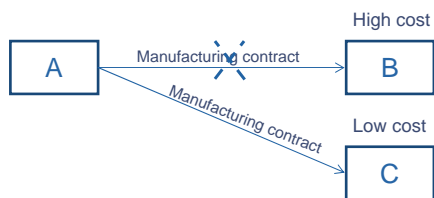
Reasoning:

- No termination indemnity is foreseen in the respective contracts
- There is no transfer of material or immaterial assets
- There is no transfer of know-how (personnel is dismissed)
- The termination cannot be considered a "service" on which a cost plus was applied in the past

Termination or substantial renegotiation of existing arrangement

OECD guidance CH9: 9.5-9.9, 9.173

- Important topic: indemnification of the restructured entity for the detriments suffered as a consequence of the restructuring
- When terminating or substantially renegotiating existing contractual relationship, the restructured entity faces various detriments
 - restructuring costs (e.g. additional write-off of assets, termination of employment contracts)
 - reconversion costs (e.g. adapt operation to other customer needs)
- Which entity should pay indemnification?



- A because termination with B will make it possible to obtain cost savings and that present value of expected cost savings is greater than indemnification (low added value manufacturing)
- C as an entrance fee to obtain the manufacturing contract (high added value manufacturing, skilled labour activity)
- Parent company if e.g. neither A nor C derive sufficient benefits from restructuring as the termination is part of a group-wide synergy attempt, decided by parent company

Termination or substantial renegotiation of existing arrangement

- To assess the at arm's length need for indemnification, examine circumstances at time of restructuring (no hindsight), particularly the rights and other assets of the parties, as well as options that were realistically available:
 - Is the arrangement formalized in writing and does it provide for indemnification clause?
 - Are the terms and clauses of the arrangement at arm's length?
 - Are indemnification rights provided for by commercial legislation or case law?
 - e.g. Distributorship agreements: terminated party has the right to claim before court an indemnification irrespective of whether or not it was provided for in the contract
 - However, in practice, an entity of a MNC group will not litigate against another associated enterprise
 - Nature of MNC's should be taken into account
- OECD guidance does not, and should not, apply differently to post-restructuring transactions as opposed to transactions that were structured as such from the beginning

Recognition of the actual transactions undertaken

OECD guidance 9.5-9.9, 9.173, 9.178

Key question:

- When may tax authorities consider disregarding taxpayer's transactions or restructuring?
 - Lack of economic substance
 - Non-arm's length risk allocation

Key thoughts:

- The OECD considers that as long as functions, assets and /or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNC group to restructure in order to obtain tax savings
- Tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. A determination that a controlled transaction is not commercially rational must therefore be made with great caution, and only exceptional* circumstances may lead to non-recognition of related party arrangements
 - The Belgian tax legislation does not provide of ways to disregard a business transaction, the recharacterisation will be based on transfer pricing adjustments, what is in line with the OECD guidance (art. 344 ITC, Brepols case law, sham transaction)

Permanent establishment issues

OECD Report on the Attribution of Profits to Permanent Establishments, parts I, II, III, par. 118

A business restructuring may involve the conversion of local entities into agent or toll manufacturing entities which may involve permanent establishment issues.

- Analyse domestic and treaty dispositions
 - Existence of a PE: international tax law prevails
 - Evidence accounting: taxable at 33,99%
 - Minimum taxable basis: 10% of gross turnover realised in Belgian PE
- Mitigate PE issues by
 - Specificities
 - Commissionaire: independent agent negative PE
 - Toller: need to avoid complete cycle of business (Art. 5 OECD MC)
 - Ascertaining an appropriate level of substance
 - Appropriately define roles and responsibilities
 - Belgian activities should act as an independent operator
 - Implement and document arm's length transfer pricing policy

Conclusion

- Huge work has been realised to come to a revised OECD guidance
- Key topic for future tax audit
- Need for robust business restructuring documentation
- *Qualitative* documentation and *substance* is required

Hugues Lamon
Partner PricewaterhouseCoopers*
TLS Corporate Tax Brussels
www.pwc.be
Tel +32 2 7107405
Mobile +32 477 509186
E-mail hugues.lamon@pwc.be

Appendix

Case study (OECD guidance 9.72)

- Related party operating as buy-sell entity
- Conversion into low risk distributor for a foreign related party
- Arm's length remuneration 2% while excess profit / loss potential would be transferred to foreign related party
- Is it reasonably acceptable for distributor to restructure, taking into account future profitability and realistic – albeit riskier – alternatives
 - à depends on historical results, volatility of those results and future profit / loss expectations

Tax effects of cross border business restructuring

Case study

Risk perspective of the distributor

Distributor's pre-conversion profits (net profit margin / sales) -Full risk activity <i>Historical data (5 years)</i>	Distributor's future profit expectations (if had remained full-risk, assuming it had the option realistically available to do so) (net profit margin / sales) <i>(Next 2 years)</i>	Post-conversion profits of the distributor – low risk activity (net profit margin / sales)
Case no. 1: Year 1: (-2%) Year 2: +4% Year 3: +2% Year 4: 0 Year 5: +6%	[- 2%; + 6%] With significant uncertainties within that range	Guaranteed, stable profit of +2% per year

INTERPRETATION

Independent's willingness to trade profit / loss potential with significant uncertainties against relatively low but stable profit depends on level of risk tolerance and possible compensation for restructuring itself

Case study
Risk perspective of the distributor

Distributor's pre-conversion profits (net profit margin / sales) -Full risk activity Historical data (5 years)	Distributor's future profit expectations (if had remained full-risk, assuming it had the option realistically available to do so) (net profit margin / sales) (Next 2 years)	Post-conversion profits of the distributor – low risk activity (net profit margin / sales)
Case no. 2: Year 1: +5% Year 2: +10% Year 3: +5% Year 4: +5% Year 5: +10%	[+5%; +10%] With significant uncertainties within that range	Guaranteed, stable profit of +2% per year

INTERPRETATION

Would independent party agree at arm's length to transfer the risks and associated profit / loss potential for no additional compensation if they had the option to do otherwise?

Case study
Risk perspective of the distributor

Distributor's pre-conversion profits (net profit margin / sales) -Full risk activity Historical data (5 years)	Distributor's future profit expectations (if had remained full-risk, assuming it had the option realistically available to do so) (net profit margin / sales) (Next 2 years)	Post-conversion profits of the distributor – low risk activity (net profit margin / sales)
Case no. 3: Year 1: +5% Year 2: +7% Year 3: +10% Year 4: +8% Year 5: +6%	[+0%; +4%] With significant uncertainties within that range (e.g. due to new competitive pressures)	Guaranteed, stable profit of +2% per year

INTERPRETATION

It is not sufficient to rely on historical data alone