Bloomberg Tax

Transfer Pricing Forum

Transfer Pricing for the International Practitioner

AUGUST 2020

Belgium

Dirk Van Stappen, Yves de Groote *and* Hanna Kerimova-Varanytska
KPMG Belgium

1. Per the OECD, the impact of the COVID-19 pandemic on economic activity would far outweigh anything experienced during the global financial crisis in 2008-09. What similarities and differences do you see between the 2008 crisis and the current pandemic so far on the practice of transfer pricing in your jurisdiction?

Since the escalation of the COVID-19 outbreak, it has become obvious that the consequences of the crisis will not be limited to the field of healthcare, but will also entail wider changes in people's lives, the organization of their work and leisure time, and the development of businesses and economies of countries around the world. New trends in customer behavior, business models and international trade flows will inevitably trigger changes to the transfer pricing models of multinational enterprises (MNEs).

If one compares the experience of Belgian companies during the global financial crisis of 2008-09 to their experience in the current turbulent economic environment, one can detect a number of similarities:

- An overall reduction in profits and the consequent need to reduce the returns of tested parties within MNEs;
- Discussions on the allocation of losses to "limited risk" entities;
- A need to adjust benchmarking studies, since such studies only reflect years of economic growth;
- The revision of centralized entrepreneur structures, intra-group financing arrangements and intellectual property (IP) flows; and
- Difficulties in aligning compensating adjustments with customs duties.

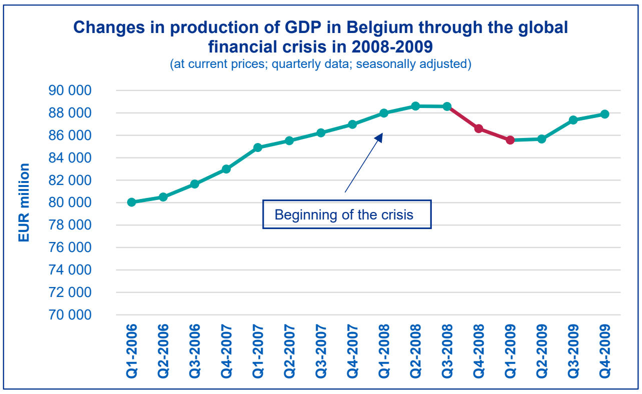
At the same time, the COVID-19 situation will far outweigh the previous recession in terms of its impact on entities' supply chains. Specifically, the COVID-19 outbreak has resulted in:

- A sudden decline in trading intensity accompanied by disruptions to, and contractions of, sourcing and procurement activities;
- Involuntary production downtime and questions relating to the treatment of related extraordinary costs;
- The unexpected cut-off of traditional channels to the markets;
- The applicability of *force majeure*, which supports arguments to the effect that part of the impact should be borne by the limited risk entities within an MNE;
- Changes in transportation flows and delivery models and the potential relocation of certain core manufacturing activities to Europe;
- Questions relating to the allocation of government support provided to MNEs (ranging from temporary unemployment benefits to more extensive support for specific sectors experiencing financial difficulties, such as the aerospace, tourism and event-related industries); and
- An abrupt increase in the purchasing of digital support services, robotics and automation investments while revenues earned by MNEs are decreasing.

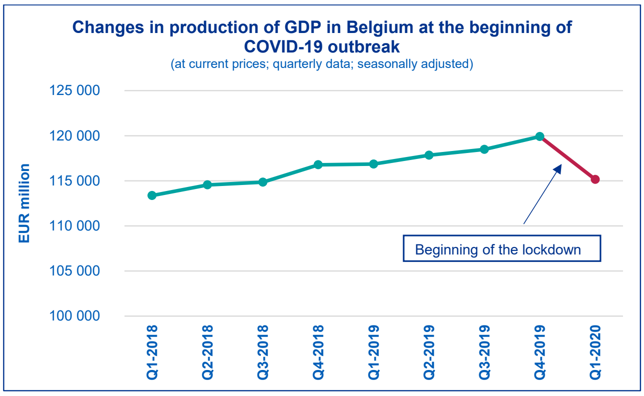
In addition, today's COVID-19-related challenges have arisen in the midst of other global tax and political trends (for example, protectionism, the introduction of unilateral tax measures and digital service tax (DST), the development of the OECD/G20 Inclusive Framework on BEPS 2.0, and initiatives with respect to climate changes after the "work from home" period), making the development of transfer pricing strategies and priorities even more complex for Belgian companies in the recovery period.

Another difference between the COVID-19 pandemic and the global financial crisis is the timing of their respective impact on the revenues of the various industries. In Belgium, the consequences of the global financial crisis for industries other than the financial industry and for the economy as a whole were deferred for two to three quarters after the beginning of the recession:[1]

TP FORUM ISSN 2043-0760



During the current lockdown, most industries and Belgian GDP as a whole registered an immediate drop in the first quarter of the downturn:[2]



Unlike during the 2008 financial crisis, enterprises had no time to review their business models, amend their payment structures or adapt gradually to the new COVID-19 challenges. On the other hand, the fact that consumers were forced to save during the lock down period will have its own impact.

2. a. What do you see as the impact of the COVID-19 pandemic on low-risk entities (which typically bear limited risks, and record limited profit margin when the principal entity incurs a loss) in your jurisdiction? Do you see your jurisdiction accepting that such entities can lose money during this unusual economic downturn?

As noted in section 1 above, the COVID-19 crisis has impacted all group entities in ways that could not have been anticipated. Local routine distribution and production sites have had to be temporarily closed, most often not because of a reduction in demand or the number of orders — in which case the closures would have resulted from a decision taken by the principal entity in a centralized entrepreneur structure — but simply because of measures imposed in the country of production and distribution, or the countries supplying raw materials or semi-finished goods.

The extraordinary circumstances of COVID-19 have impacted not only principal entities, but also third-party and related-party contract manufacturers/distributors. Third-party contract manufacturers will most likely not have been able simply to pass on to their principals the exceptional inactivity costs they have incurred. Third-party routine distributors will generally also have continued to pay local rental payments, without automatically recharging such costs to brand owners, even though retail outlets were temporary closed and, for a few months, there was no or only limited turnover. Thus, where an arrangement is in place with routine third-party entities, it will generally not be only the principal entity that has incurred additional lockdown-related costs. It is also worth pointing out that contract manufacturers/limited risk distributors might also be willing to lower their margins slightly or to bear losses in order to avoid their principal entities having to file for bankruptcy.

The transfer pricing Circular published by the Belgian tax authorities on February 25, 2020 (the "Belgian Circular")[3] includes provisions regarding costs linked to inefficiencies and exceptional costs:

- Section 48: "It is generally accepted that costs that are higher as a result of a lack of effectiveness should be borne by the company that renders the products or services, as it is that enterprise that is able to **influence the magnitude of such costs**. Under such circumstances, an independent buyer would not agree to adjust the price;"
- Section 181: "The tax administration estimates that in the case of the application of the cost plus method or the transactional net margin method based on costs, the following elements should be taken into account: (i) [...]; (ii) the profitability of a service rendering company that assumes limited risks, should in principle be guaranteed and should as a result not be impacted negatively by financial or nonrecurring charges **that would not correspond to the functional profile** of the services provider."

It is not unreasonable to assume that the same reasoning can also be applied to COVID-19 related inactivity costs, i.e., "as it is that enterprise that is able to influence the magnitude of such costs". Since it is very difficult for a principal entity to manage *force majeure*-type events/costs, it seems likely that such costs should not be entirely recharged to it. At the end of the day, "limited risk" does not mean "no risk."

b. Are there MNEs in your country who are experiencing or likely to experience increased or expanded business opportunities despite the current pandemic? What strategies should these entities be mindful of with regards to their transfer pricing models?

In Belgium, the MNEs that have been able to expand their business opportunities and to maintain or increase their growth level are mostly MNEs operating in the IT, communications, food and pharmaceutical industries. However, it should be noted that the results vary widely, depending on the business lines within such MNEs.

In the case of an MNE operating in one of these industries, it will be necessary to review how the excess profit generated should be allocated amongst the MNE's members. It will also be important to establish which MNE member was able to identify and grasp a specific opportunity that presented itself in the context of the COVID crisis, since that entity should probably be allocated a substantial share of the return realized.

Companies operating in the pharmaceutical sector may have supported governments by providing testing materials or conducting vaccine research. An MNE may have carried out such activities at or below cost with a view to preserving its reputation and improving its long-term relationship with the government concerned. In such circumstances it will be important to identify the beneficiary of such investment and which entity should be bearing the related costs.

c. How are MNEs in your jurisdiction addressing comparability issues, or how would you advise them to address comparability issues? How should they treat loss-making comparables, to ensure that any adjustments factor in the current global epidemic and adequately reflect economic reality?

Recovering from the effects of COVID-19 is expected to be a lengthy and challenging process. Transfer pricing benchmarking studies based on the transactional net margin method typically refer to the performance of comparable independent companies over the past three to five years. However, the companies most affected will go out of business and disappear from the final sets, causing additional bias.

The Belgian Circular indicates that comparables that have experienced two consecutive loss-making years should be excluded from the final set when testing limited risk-type entities. One can legitimately ask how relevant this guidance is in the current circumstances.

Due to the standard one-year delay in the availability of financials of independent companies, documenting the transfer prices to be applied for the financial year 2020 would commonly refer to comparable financial information from the period of 2017 to 2019. Taking into account the expected severe financial downturn, the performance of the independent comparables over this period would no longer provide an accurate benchmark.

Possible approaches to improving comparability and adjusting such benchmarking study results could include:

- Positioning at the lower end of the arm's length range (i.e., targeting closer to the 25th percentile instead of the median). In this respect, Section 126 of the Belgian Circular indicates that a position within the interquartile range should be acceptable: this assumes that the final set of comparables obtained through the benchmarking study is comparable to the greatest extent possible.
- Positioning in the 25th percentile will not be sufficient for certain MNEs in certain industries. Alternative methods will therefore have to be defined based on quantifiable data available on the market. Such market information could include the drop in the country's GDP, sector specific information or quarterly results published by quoted companies. Taking into account the margins earned during the previous financial crisis could also suggest the size of the adjustment to be made. Any such approach should be well-documented and very carefully implemented in practice, since it could present the most risk in the context of a transfer pricing audit.

d. How likely are the tax authorities in your jurisdiction to consider ''economic circumstances'' as a relevant comparability factor?

The Belgian tax authorities have been taking a proactive approach in considering the transfer pricing related impacts of the COVID-19 crisis, conducting "brainstorming" sessions and modelling changes in the transfer pricing policies arising from the current economic circumstances. They have also created an internal workgroup with a view to aligning opinions on what will and what will not be acceptable. This COVID-19 workgroup on transfer pricing matters is mainly composed of the same parties as worked together on the recently published Belgian Circular.

The Belgian tax authorities will take into account the economic circumstances surrounding intercompany transactions. For example, Section 68 of the Belgian Circular contains the following statement: "Adjustments are possible if the actual costs associated with the transactions deviate abnormally from the budgeted costs for *any economic reason* [...]," and Section 82 of the Belgian Circular explicitly provides a standard list of economic circumstances to be taken into account in carrying out the comparability analysis (including government regulations and other factors).

3. How do you see the pandemic affecting APAs? What adjustments are MNEs making — or what adjustments should they make — to ensure that they will be considered to be in compliance with their agreements? Are companies looking to amend (or should they look to amend) their APAs, or are they just documenting changes in anticipation of possible future amendments?

MNEs with existing APAs might be well advised to document all current changes and to gather all supporting evidence and facts with respect to the challenges they are now facing. To the extent the facts and circumstances described in an APA are still in line with the description in the APA, the APA should remain valid. However, if any critical assumptions underlying the APA have been violated, it will be necessary to approach the tax authorities to discuss their impact.

Another option is to approach the tax authorities proactively with a view to renegotiating existing APAs in light of the exceptional circumstances under review, even if the functional profile of the parties concerned has not changed. In this respect, the taxpayer might wish to discuss the application of a new transfer pricing methodology and/or margins (for example, taking a lower position within the range), in view of the changed economic circumstances.

However, it should be borne in mind that the APA teams may be reluctant to reopen negotiations if they feel that the reopening of an APA is inspired more by tax optimization considerations than by genuine operational difficulties.

4. Do you think there is a ''silver lining'' or bright spot about this economic situation that MNEs should be mindful of? What are possible opportunities that otherwise would not be sustainable in the absence of an economic crisis? Reset possibilities? Location-specific advantage?

The COVID-19 crisis may also create the momentum for an MNE to change its transfer pricing model, whereas, in times of economic growth, the conversion of a transfer pricing model can result in a high exit tax risk. For instance, converting from a limited risk to a profit split model might — in the short term — represent a solution to the problem of how to spread losses among the different entities within an MNE. The tax authorities of the former principal might be less aggressive regarding exit tax issues where losses have been relocated mainly abroad. The foreign entities concerned might not challenge the losses so allocated, since they will enjoy greater profit potential in the long term.

Dirk Van Stappen is a Partner, Yves de Groote is a Partner, and Hanna Kerimova-Varanytska is Supervising Senior Advisor, in KPMG's Global Transfer Pricing Services group in Belgium.
They may be contacted at:
dvanstappen@kpmg.com
ydegroote@kpmg.com
hkerimova@kpmg.com
www.home.kpmg.com/be/en/home.html

NOTES

[1] OECD Statistics, Quarterly National Accounts: GDP (output approach) — Belgium: Q1 2006 — Q4 2009. (*https://stats.oecd.org/index.aspx?queryid=60702*)

[2] OECD Statistics, Quarterly National Accounts: GDP (output approach) — Belgium: Q1 2018 — Q1 2020. (*https://stats.oecd.org/index.aspx?queryid=60702*)

[3] Fisconet*plus*, Circulaire 2020/C/35.