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Branch Reporter
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1. Introduction[1]

This report provides an overview of how to assess the profits of Belgian establishments and/or foreign permanent establishments (PEs) under Belgian law and the provisions of the OECD model tax convention (OECD MTC).

Unless expressly mentioned otherwise, this report deals only with cross-border company profits. The focus is therefore on the allocation and distribution of profits between a PE and its head office for income tax purposes. Please note that this report does not discuss certain types of companies, such as agriculture and forestry companies, shipping and air transport concerns, and management companies formed by performing artists (so-called "star companies").

Although the OECD MTC contains a comprehensive set of rules on the attribution of profits to a PE, it does not define the concept of "profits" as such. The commentary to the convention indicates that this term should be interpreted broadly to include all income realized in the course of a company's operations. Consequently, in defining the term "profits" reference should be made to national law.

2. The situation under Belgian tax law

2.1. Background issue: definition of a Belgian establishment (BE)

As a general rule, profits of a foreign company are subject to Belgian tax only if the company disposes of one (or more) BEs.

A (basic rule) BE is any PE that a foreign company uses for all or some of its operations in Belgium. Examples include places of management, branches, offices, factories, workshops, warehouses and inventory. The definition of BE is

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1 Due to budgetary constraints, this report cannot be published to its full extent. However, the entire version of this report, i.e. with full reproduction of the footnotes, can be obtained either from the IFA's General Secretariat (n.gensecr@ifa.nl) or the author (tim.wustenberghs @tiberghien.com). It should also be noted that a more detailed version of this report is published in the IBFD *Bulletin* (2006).

therefore very similar to that of a PE within the meaning of article 5(1) OECD MTC. However, these definitions differ in certain essential respects. Notably, the concept of BE under Belgian law is unarguably broader than the concept of PE so that any place of business that qualifies as a PE under the OECD MTC is deemed a BE, while the reverse is not necessarily true. Hence, the threshold under Belgian law is lower.

Moreover, the presence on Belgian territory of an agent, other than an independent agent acting in the ordinary course of his business, could also give rise to a BE. The same holds true even if the foreign company has no fixed place of business in Belgium. Unlike the OECD MTC, an agency BE can arise even if the agent has no power to enter into contracts in the name of the foreign company.

Profits attributed to a BE, including business income as well as (recognized or realized) capital gains on assets invested in the establishment, are subject to Belgian non-resident income tax (NRIT) at a rate of 33.99 per cent. It should be noted, however, that only net profit is taken into account in calculating the tax liability, meaning that business expenses can be deducted.

2.2. The allocation of profits to a BE

As a general rule, foreign companies are only subject to Belgian NRIT on income realized in Belgium through a BE. Thus, there is no force of attraction rule. If a foreign company realizes a profit in Belgium without the involvement of the BE, this profit should not be attributed to the BE. In practice, this means *inter alia* that income derived from personal property can only be attributed to this BE if the property that produced the income (i.e. shares, loans or intellectual property rights) can be so attributed.

The question then arises as to which method should be used to allocate profits to a BE. The starting point is the BE's accounts. However, this rule presupposes that the accounts have probative value. Yet this does not necessarily mean that the accounts should accord with Belgian accounting law. Indeed, statements from foreign accounts or other evidentiary documents can be used.

The allocation of profits based on the BE's accounts is commonly referred to as the "direct method".

The direct method requires that the BE be regarded as separate from the foreign head office and any other foreign establishments it may have for tax purposes. This fiscal personification of the BE is obviously a fiction, as it is not an independent entity in legal terms; the BE is only part of a larger entity, i.e. the foreign company on which it depends. In terms of private law, it is theoretically impossible for a BE to enter into agreements with its head office as it is impossible for a company to conclude contracts with itself. However, tax law does not follow this analysis. As mentioned above, tax law starts from the assumption of fictitious independence ("independence fiction"). In other words, it assumes fictive transactions between the BE and its head office.

The independence fiction also implies that in determining the BE's profit abstraction is made from the global result of the foreign head office. Thus, the BE will be subject to tax in Belgium for any profit that can be attributed to it, even if the company as a whole is in a loss position.

Nevertheless, the independence fiction should not be carried to an extreme. The purpose of this fiction should always be kept in mind, namely to provide a basis for tax assessment. As a result, the repatriation of profits from a BE to its head office is not considered a dividend distribution subject to withholding tax.

The independence fiction under Belgian tax law was originally a jurisprudential creation. In this respect, reference is made to case law of the Court of Cassation holding that operations booked by a BE make up an economic and fiscal unity that must be distinguished from the factual universality constituted by the foreign company. The Court based its ruling on current articles 26, 233 and 235 ITC which counter earlier provisions in the law.

To date, the exact scope of the independence fiction remains unclear. The tax authorities and the prevailing doctrine seem to support a narrow interpretation that leaves aside internal (intra-company) dealings in calculating profit. For example, the tax authorities will invariably disallow the deduction of internal interest payments, royalties and rent (see below). Likewise, when assets are transferred from a Belgian head office to a foreign PE, no capital gains will be recognized as long as the establishment does not sell the assets to a third party and no (production or sales) profit is actually realized (see section 2.3). In other cases, however, the independence fiction is applied rigorously. Accordingly, a transfer of assets from a BE to its foreign head office will result in the allocation of profits to the BE, even if none is actually realized within the scope of the company at large, or, as the case may be, not yet realized in the same tax period.

This ambiguity is (in the reporter's opinion) due to pragmatic application and interpretation of article 26 ITC.

The question arises, however, as to whether there is still room for a limited or restricted independence fiction under Belgian tax law since the introduction of article 185(2) ITC. This provision introduced into the ITC the arm's length principle of article 9(1) OECD MTC as well as the principle of correlative (downward) corrections in accordance with article 9(2) OECD MTC, in order to prevent double taxation arising from transfer pricing adjustments. Based on the text of the law, it can be inferred that the scope of the new provision only covers cross-border transactions between autonomous enterprises belonging to the same group of companies (article 185(2) ITC), on the one hand, and between a BE and its foreign head office (article 235(2) ITC), on the other. However, it is not clear whether this provision also applies to cross-border operations between PEs (including BEs) and between a foreign PE and its Belgian head office. The reporter is of the opinion that good arguments exist to answer this question in the affirmative. In this respect, support can be found in the legislative history and the principle of legislative intent. However, in order to avoid insofar as possible future debate, the legislator should take the initiative to align its clear intent with the language of the law.

Certain authors defend the theory that article 185(2) ITC applies only if the taxpayer has submitted a request for an advance tax ruling or if an international procedure is pending, i.e. within the scope of legal proceedings, aimed at the elimination of double taxation (such as the EU arbitration procedure or the mutual agreement procedure mentioned in the double taxation conventions (DTCs)). According to these scholars, dealings between a BE and its foreign head office are enduringly governed by traditional transfer pricing rules (including article 26 ITC, see below) if the taxpayer has not submitted a request for an advance ruling.

In the reporter's opinion, however, this position requires some clarification. After all, article 185(2)(2) provides that the international arm's length criterion also applies outside the context of advance tax rulings ("without prejudice to the application of"). Therefore, the new provision would appear to have a much broader scope. Consequently, it should be taken into account if a DTC applies to the situation in question (in the present case article 7 of the OECD MTC).

If this position is followed and if it is accepted on the basis of the legislative history that article 185(2) ITC introduced an unlimited independence fiction with respect to transactions between PEs, on the one hand, and between a BE or Belgian head office and its foreign head office or foreign PE, on the other hand, there will obviously be a number of important consequences. Basically, the result of the introduction of article 185(2) ITC would be that profits realized by the BE will have to be accounted for as if it were dealing, rather than with its head office or other PEs depending on it, solely with independent companies in a free market place. The consequences are twofold. On the one hand, the tax authorities have discretion to increase the profits of the BE (or the Belgian head office, as the case may be) when profits are transferred abroad. The profits of the BE must be determined based on the operations it carries out and the risk it bears. On the other hand, for tax purposes it is also necessary to acknowledge the existence of agreements between the head office and its BE. Accordingly, the deductibility or taxability of interest, royalties and rent between the head office and its BE should be accepted by the tax authorities. In addition, transfers of goods and/or services should, as a rule, respect the arm's length principle. This issue is discussed in more detail below (see section 2.5.2).

Apart from theoretical considerations with respect to the independence fiction, the question of a detailed assessment of profits (and expenses) of a BE arises. Obviously, the starting point is the BE's accounts. However, certain corrections may need to be made before a definitive tax assessment can be made.

As regards proceeds from transactions in the ordinary course of business (i.e. transactions with third parties), a distinction can and should be made between transactions carried out by a BE alone and those conducted together with its foreign head office. In the first case, no additional problems arise. The total purchases made and sales realized are included in the BE's accounts. Consequently, profits are calculated in the same way as for a Belgian company. In the second case, however, the independence fiction is applied to solve the issue of allocation of profits, meaning that the proceeds the BE would have realized had it been an independent company cooperating with its foreign head office must be attributed to it. In other words, a benchmark study must show how independent actors would have allocated the profits under similar circumstances. Obviously, this will depend on the functions performed by the BE, for whom they are performed, and the risk the BE assumes in doing so.

Proceeds from dealings between a BE and its foreign head office should as a rule be determined at arm's length. If a BE supplies inventory, assets or services to its foreign head office, its profits should be determined as if it were an independent company and, that being the case, it may be necessary to examine whether the profits as they appear in the accounts should be corrected. Traditionally, article 26 ITC has been interpreted to mean that a BE may not grant its foreign head office any abnormal or benevolent advantages. The provisions of article 185(2) confirm this position. For more information, refer to section 2.5.

Belgian tax law does not contain an exception for BEs whose activities are limited to the purchase of goods for its foreign head office. If no DTC applies, a normal profit margin or commission will be attributed to the BE as if it were a purchasing agent.

The proceeds of a BE also include income derived from movable and immovable property invested in the establishment, as well as any recognized or realized capital gains on assets so invested, including capital gains from the alienation of the BE.

Article 237 ITC governs the deduction of costs and business expenses. Obviously, business expenses and costs are set off against the profits of the BE. In general, expenses incurred by the BE in the ordinary course of business, as well as those incurred by the head office for the purposes of the BE, may be deducted. However, any such costs must be attributable exclusively to the BE. Therefore, the foreign enterprise must demonstrate that the expenses incurred or borne were for the sole purpose of the BE. Accordingly, national law contains a so-called "specificity rule", obliging the Belgian tax authorities to adopt a stricter position than that advocated by the OECD MTC.

Pursuant to this specificity rule, the profits of a BE may not be reduced by a proportionate part of the foreign company's overhead expenses unless a DTC applies (see section 3.3). Furthermore, the foreign head office cannot allocate part of the fee it pays its directors to reduce the profits of the BE, unless and to the extent that the fee relates to activities the directors performed in Belgium for the purposes of the BE. Moreover, the Belgian tax authorities will disallow the payment of a *praecipuum* by a BE to its foreign head office, i.e. a lump-sum share of the BE's profit in return for good management.

Finally, it should be noted that Belgian tax law does not allow the deduction of interest, royalties and rent paid by a BE to its head office or to another establishment of the foreign head office. Clearly, there is in this respect a limited application of the independence fiction under national law. In light of new article 185(2) ITC, however, a few question marks are in order here. For instance, it may be relevant to consider why the fact that the BE and its head office form part of the same legal entity is disregarded for certain dealings (which must be deemed executed by two separate undertakings) but not for others, such as contracting loans and licensing of intellectual property rights.

As mentioned above, the direct method is the appropriate method to establish the profits of a BE. In theory, this method presupposes that actual accounts with probative value are available. However, if this is not the case, the Belgian tax authorities can determine the profits attributable to a BE on the basis of a comparison procedure, as set out in article 342 ITC, meaning that the BE's profits can be determined through a comparison with those realized by three similarly situated taxpayers.

Furthermore, within the same context, the Belgian king has been authorized to fix at a flat rate basis the minimum amount of profits on which foreign enterprises operating in Belgium are taxable. The king has taken advantage of this authority and has drawn up rules contained in article 182 RD/ITC. Once again, these rules can only be applied if the BE fails to produce sufficient evidentiary documentation. The minimum amount of profit varies depending on the sector in which the foreign enterprise is active and the number of employees or level of sales realized in Belgium. The absolute minimum is EUR 9,500. Because the profits so attributed to a BE are found to be *de minimis*, they cannot be reduced by deducting any business expenses. Nor can the amount be reduced in proportion to the number of months the activity was performed in Belgium during the relevant tax period.

The foregoing does not adversely affect the possibility for a foreign enterprise to apply to the Belgian tax authorities for an advance tax ruling on the method to be used to assess the profits of its BE prior to taking up activities in Belgium. Such rulings do not pronounce on the amount of profit attributable to the BE; they only set forth the methodology to be used and the applicable profit margin (depending on the functions carried out, the risk borne and the assets utilized).

2.3. The assessment of profits of a Belgian company with a foreign PE

Belgian companies are subject to tax on their worldwide income. Thus, foreign source income is subject to Belgian corporate income tax (CIT) unless provided otherwise under applicable law. In other words, within the same legal entity – a head office and its PE are part of the same legal person – there is a kind of tax consolidation or, to use the language set forth in case law and literature, a "unification of profit" or "consolidation of the taxable basis". Regardless of the source of the income, however, it is imperative that the taxable basis be established in accordance with Belgian tax law.

Most countries require a branch to keep separate accounts. According to Belgian law, the figures of these foreign-based branches should be included in the Belgian accounts of the head office at least once every six months. When integrating the figures, the Commission for Accounting Standards specifies that only assets and liabilities with respect to third parties and proceeds from transactions with third parties should be taken into account, i.e. receivables and debts exchanged between the branch and its head office as well as proceeds and expenses pertaining to dealings between the two are ignored.

The question arises as to whether the independence fiction discussed above also applies to the foreign PE of a Belgian company. In other words, should a foreign PE be considered a separate and independent company for Belgian tax purposes? This question is not merely of academic interest as correct identification of profit is necessary for treaty purposes (i.e. in light of the exemption for profits attributable to a PE) as well as under national law (i.e. in order to facilitate the proper characterization and allocation of losses in accordance with the provisions of articles 75 *et seq*. RD/ITC).

Due to consolidation of the taxable basis, certain scholars reject the idea that the foreign PE of a Belgian company should be considered as a separate person for tax purposes. After all, the income attributed to the PE remains that of the Belgian company as such. Furthermore, the rules of DTCs (*in casu* article 7(2) of the OECD MTC) do not fundamentally affect domestic law (see section 3.2 of this report, however).

These scholars believe that article 26 ITC cannot be applied to dealings between a Belgian head office and its foreign PE. Based on the principle that a Belgian company and its foreign PE are part of the same legal entity, the Ruling Commission (*Commissie voor Voorafgaande Fiscale Akkoorden*) decided in 1993 in the same sense, i.e. it rejected the application of article 26 ITC to abnormal or benevolent advantages granted by a Belgian company to its foreign PE since article 26 applies only to benefits granted to third parties, not to dealings within the same legal entity. Consequently, a Belgian company cannot be taxed on profits from notional dealings; the concept of internal profit realization is not accepted in the relationship between a Belgian head office and its PE. In fact, for profit from dealings between a Belgian head office and its foreign PE to be liable to tax, it is required that the profit be included in the company's worldwide income as a result of transactions with third parties. This doctrine is called the *leer van het gedeelte*.

On the other hand, some commentators accept the application of a (limited) independence fiction for foreign PEs of Belgian companies. In their view, it should be possible to readjust the profits of a foreign PE if it is obvious that these profits were artificially shifted.

These commentators refer to article 26 ITC to assume an independence fiction for foreign PEs of Belgian companies. Abnormal or benevolent advantages granted to a foreign PE must therefore be added back to the profits of the Belgian head office. They rely as to that not only on the spirit of this provision, but also on a strict reading of it. In fact, article 26, al. 1 ITC does not specify (or therefore restrict) to whom such abnormal or benevolent advantages can be granted. Moreover, article 26, al. 2 merely refers to a "foreign establishment".

The applicability of article 26 ITC to dealings between a Belgian head office and its foreign PE has been confirmed by a judgment of the Mons Court of Appeal. This case involved a Belgian company that had granted an interest-free loan to its Spanish PE. According to the court, the Belgian company should have included the lost interest in its tax base. The head office was therefore deemed subject to tax on fictitious interest, i.e. interest which was totally absent from the company's worldwide income.

However, even commentators who base the independence fiction on article 26 ITC are critical of this decision which they feel ignores economic reality, on the one hand, and the so-called *leer van het gedeelte* (see above), on the other. The Belgian company's income is consolidated with that of its PEs and, therefore, no fictitious profit can be taken into account that is not actually present in the company's global profit. The issue of realization only arises if and when transactions with third parties outside the company occur.

If Belgium has concluded a DTC with the PE state, the author none the less supports a more rigorous application of the independence fiction in the relationship between the Belgian head office and its foreign PE. In this respect reference is made to new article 185(2) ITC (see above). The profits should be treated as if the transaction took place between two independent companies, therefore presupposing *a fortiori* the application of arm's length conditions.

If goods are transferred from a Belgian head office to its foreign PE, the arm's length principle must prevail, meaning that the head office will be taxed on any capital gains. Conversely, when tangible fixed assets are transferred from a foreign PE to its Belgian head office, the depreciation basis should be equal to the higher transfer price. In other words, the depreciation should be calculated in the hands of the Belgian head office on a step-up. Moreover, consequent application of the independence fiction under national law should result in the acknowledgement, for instance, of loan, licensing and lease agreements between the Belgian head office and its foreign PE. Accordingly, the assessment of profits should take into account the existence of (fictitious) interest, royalties and rent flows. Section 2.5 contains a detailed discussion of these various dealings.

2.4. The avoidance of double taxation between a Belgian head office and its foreign PE

Until recently, Belgian tax law provided, in addition to a deduction of the taxes paid in the source state (as a business expense), for a flat-rate relief from double taxation for profits realized by a Belgian company abroad. Specifically, the law provided that the CIT proportionally related to a foreign PE's profits be reduced to one-quarter. Even though the avoidance of double taxation is generally seen as a fundamental objective of international tax law, the Belgian legislature deemed it expedient to repeal this unilateral measure. Henceforth, the profits of a foreign PE will (if no DTC is in place) be once again subject to CIT in Belgium in the hands of the Belgian head office. A remarkable result!

Outside the treaty context, profits from internal dealings may under no circumstances be attributed to a foreign PE (see section 2.3 above). Consequently, there is no risk of double taxation in Belgium as a result of such dealings.

2.5. The allocation of profits in the case of internal dealings

2.5.1. General remarks

The following discussion focuses on the treatment of internal dealings under Belgian tax law. The basic assumption is that the company's head office or PE, as the case may be, is established in a country with which Belgium has concluded a DTC, in which case article 185(2) ITC applies. You will recall that, according to its legislative history, this provision introduced the internationally accepted arm's length criterion into Belgian tax law and provided a legal basis for the (absolute or unrestricted) independence fiction. Hence, profits can be subject to tax, even if not yet actually included in the company's global result.

The question arises, however, as to whether we have jumped too hastily to a conclusion liable to run contrary to the "reality principle" applicable under Belgian tax law. The independence fiction relies, as its name implies, on a fiction and should thus be interpreted narrowly. For that reason, transfer pricing adjustments in the event of a temporary transfer or disposal of assets to a foreign PE should be limited to effective costs, i.e. without application of a mark-up. The reporter believes the same holds true for internal supplies of services insofar as the services do not form part of the core business of the head office or PE.

2.5.2. The transfer of inventory

2.5.2.1. From a Belgian head office to a foreign PE

Based on the independence fiction, a transfer of inventory from a Belgian head office to its foreign PE is a taxable event. Consequently, the inventory should be charged by the Belgian head office applying the arm's length method. As a result, the difference between the fair market value and the book value of the inventory will be subject to CIT.

The question arises, however, as to which tax period to allocate this profit. What happens if the inventory is sold to third parties in a subsequent tax period? Under domestic law, there are grounds for deferring taxation until actual realization of the inherent gain. In this respect, reference can be made to the above-mentioned "reality principle". This means, in the reporter's opinion, that the further course of the goods must be noted in order to verify whether the allocation of profits can be justified. Taxation would have to be deferred until the assets were transferred outside the company. In addition, equity considerations also underlie this position. In our opinion, however, a prior legislative initiative will be required, although support can be found in article 360 ITC, which provides that taxes shall be levied only for income that the taxpayer actually received (not accrued) in the tax period.

2.5.2.2. From a foreign PE to a Belgian head office

In this case as well attention should be paid to the arm's length principle. If the price paid by the Belgian head office is too high, profit is shifted abroad. An adjustment can be made based on article 26 or 185(2) ITC. Conversely, if the invoiced price is too low, the Belgian company will be deemed to have obtained an abnormal advantage. In that case, article 207, al. 2 ITC may apply to disallow certain deductions (the participation exemption, losses, notional interest deduction, etc.) to the extent that the abnormal advantage thus received is included in the company's result.

2.5.2.3. From a BE to its foreign head office

If inventory belonging to a BE is transferred to its foreign head office, the difference between the fair market price of the goods and their book value will be subject to NRIT. According to the Belgian tax authorities, taxation should occur for the year in which the transfer takes place, as they treat such a transaction as a "realization". The merits of this position are dubious in view of the discussion under section 2.5.2.2 above.

2.5.2.4. From a foreign head office to a BE

An inbound transfer must be accepted for tax purposes, as long as the arm's length standard is applied and the goods can actually be allocated to the BE.

2.5.3. The transfer of capital equipment

2.5.3.1. From a Belgian head office to a foreign PE

There are two ways for a foreign PE to acquire the assets it requires to carry out its activities. The head office can provide the PE with sufficient financial means for the PE to acquire the assets itself or the head office can acquire the assets and subsequently transfer them to the PE. In any case, assets must be allocated to the PE at their correct value. According to Belgian tax law, this value corresponds to the fair market value of the assets at the time of allocation. If necessary, an adjustment may need to be made based on the arm's length principle.

A transfer at fair market value may imply the realization of latent capital gains in the hands of the Belgian head office. These gains are taxable for the year in which the actual transfer occurs. Any possible future capital gain that the foreign PE may subsequently realize will be attributed to the PE. In accordance with the jurisprudence of the Court of Cassation, capital gains which the Belgian head office did not play a role in realizing are indeed considered foreign source profits.

2.5.3.2. From a foreign PE to a Belgian head office

The reporter thinks it doubtful that assets can be transferred from a foreign PE to its Belgian head office at book value. Based on the independence fiction, a mark-up is called for. Nevertheless, this would also imply that depreciation should be calculated on the value as fixed at the transfer date.

2.5.3.3. From a BE to its foreign head office

The transfer must respect the arm's length principle. Application of the fair market value may give rise to taxation of latent capital gains in the hands of the BE.

2.5.3.4. From a foreign head office to a BE

If a foreign head office transfers assets to a BE, the BE must book the assets at their fair market value for tax purposes. The fair market value will also be used as the basis for depreciation. If an excessive price is used, the Belgian tax authorities can of course disallow a part of the depreciation.

2.5.4. The transfer of intangible assets

2.5.4.1. From a Belgian head office to a foreign PE

The same conclusions apply *mutatis mutandis* as explained in section 2.5.3.2 above for a final transfer of intangible assets. Such a transfer is indeed a taxable operation that must be valued at market conditions. None the less, if only a right to use intangible assets is granted, the question arises as to the tax treatment of the intra-company royalties. As stated above, the Belgian tax administration is traditionally reluctant to recognize the notional payment of royalties. In light of the independence fiction, however, the reporter believes that good grounds exist to maintain that the licensing of an intangible asset is an internal dealing for which an arm's length compensation should be received.

2.5.4.2. From a foreign PE to a Belgian head office

As far as a final transfer is concerned, reference is made to the conclusions under section 2.5.3.3 above. If only a right to use an intangible asset is granted to the Belgian head office, the deductibility of royalties in its hands ought to be recognized based on the independence fiction. To date, however, the Belgian administrative commentary to the DTCs expressly states that intra-company royalties are not taken into account for tax purposes.

2.5.4.3. From a BE to a foreign head office

If a BE permanently transfers intangible assets to its foreign head office, the purchase price must once again be determined at arm's length. The Belgian tax authorities will probably not oppose this position as they, from this standpoint, no longer risk losing the taxing rights over the assets involved.If the BE grants a right to use an intangible asset to its foreign head office, the BE should in principle be taxed on the royalties it receives.

2.5.4.4. From a foreign head office to a BE

If a final transfer of intangible assets occurs, reference is made to the conclusions under section 2.5.4.1 above. However, if only a right to use intangible assets belonging to the foreign head office is granted to the BE, the latter should be able to deduct the royalties it pays pursuant to the independence fiction.

2.5.5. The supply of services

A distinction should be made based on whether the services supplied are considered the company's core business (i.e. as a rule the company supplies similar services to third parties) or are incidental and/or are part of the general managerial services of the company at large.

If all or part of the activity of the head office or the PE consists of supplying services to third parties at market price, the same remuneration must be charged when similar services are supplied to the PE or the head office, respectively. In other words, under Belgian tax law, an arm's length price must be applied as if the services were supplied to an unrelated third party. If there are no external benchmarks, one could consider the application of the cost-plus method, i.e. a mark-up should be calculated on the expenses related to the services in question.

The foregoing implies that the taxable basis must be increased by a notional profit margin if the Belgian head office or the BE supplies the services. If, on the other hand, the Belgian head office or the BE is the beneficiary of the services, the Belgian tax authorities should allow deduction of notional business expenses.

At times, however, services are supplied which have a rather more supporting character, or form part of the general management of the company at large. Examples are collecting market information for the foreign head office, advertising goods that the establishment, however, does not sell (first category), organizing joint training programmes for executives, supplying administrative and accounting services (second category), etc. In such situations, it is appropriate to allocate the respective costs without any mark-up or to allocate expenses to those parts of the company that actually benefit from them. In other words, these services must be supplied at their historic cost.

As regards expenses related to services in the second category (i.e. general management costs), one should bear in mind that if a foreign head office supplies such services to a BE, the latter will not be allowed to deduct these expenses under Belgian tax law (see section 2.2 above).

2.5.6. The provision of capital by a head office to a PE

To date, under Belgian tax law there has been no minimum capital requirement for PEs. In reality, this means that there are no specific thin capitalization rules for PEs, unlike for independent subsidiaries. As a rule, however, this does not prevent the tax authorities from taking into account the capital a head office allocates to its PE and which is registered in the latter's financial accounts.

2.6. Agency PEs under Belgian law

An agent operating in Belgium can give rise to an agency BE for its foreign principal. The amount of profit attributable to the BE will in practice be determined in accordance with the agent's role in the sales process. As a rule, profit is fixed on a commission basis, i.e. as a percentage of sales. The applicable percentage, however, will vary depending on whether the representative qualifies as a commissionaire, a sales representative or an apparent agent. Each type of agency carries its own risks. Moreover, in determining the commission fee, the agent's efforts (notably whether the agent must deal with existing clients or look for new ones), the reputation of the product (a well-known brand will result in the attribution of less profit), and other factors must be taken into account.

If the agent only has the power to accept orders and is not authorized to bind the foreign head office, an agency PE is likely to arise. Belgian tax law, however, explicitly provides for a tax exemption in this case (albeit on a reciprocal basis). Other purely supporting functions (such as handling administrative tasks upon the delivery of goods, e.g. customs formalities) will probably not give rise to an agency PE. In such a case, however, a basic rule BE may arise, in which case the tax liability should be determined on a cost-plus basis.

2.7. Specific issues relating to banks and insurance companies

Basically, a foreign bank or insurance company is only subject to tax in Belgium if it disposes of a BE. These companies are therefore subject to the same criteria outlined in section 2.1 above. This means that, as a rule, the direct method must be applied to assess their profits (see section 2.2 above).

For banks, however, there are two peculiarities worth mentioning. First, the Belgian tax authorities have always accepted, in line with the OECD position, the deductibility of internal interest payments, the reason being that granting and receiving loans is their core business. Second, the possibility exists of assessing the profits of a bank's BE on a flat-rate basis. In principle, this method will only be applied, as mentioned above, if accounts or documents with sufficient probative value are lacking. For banks, the flat-rate assessment for tax purposes is EUR 24,000 per employee.

A flat-rate assessment also applies, in the absence of sufficient evidentiary information, to foreign insurance companies. In that case, their profits are assessed at a flat rate of EUR 2.50 per each EUR 25 of premiums collected. It should, moreover, be mentioned that the tax authorities, in consultation with representatives from the insurance sector, have also established a flat-rate basis of assessment within the framework of the comparison method.

3. The impact of DTCs

3.1. Background to Belgium's DTC network

As of 1 September 2005, 85 bilateral DTCs were in force in Belgium. Belgium has concluded DTCs with all European Member States and industrialized Anglo-American countries as well as with a large number of African and Asian countries (including Hong Kong). As a matter of principle, Belgium does not conclude DTCs with countries deemed to be tax havens.

Most Belgian tax treaties (with industrialized countries) are based on the OECD MTC; a minority are based on the UN MTC (especially DTCs with developing countries). Belgium's double tax treaty with France is a special one due to its distinctive language and structure.

3.2. The significance of DTCs under Belgian law

DTCs prevail over Belgian law. Therefore, Belgian tax law will not apply if and to the extent that it is incompatible with a DTC. The Court of Cassation phrased this principle in clear terms in its *Franco Suisse Le Ski* judgment. The fact that a Belgian law is needed to ratify the DTC and therefore to transpose it into national law does not affect the prevalence of DTCs over national legislation. After all, DTCs are an autonomous and coherent legal order that exists in tandem with, but at a higher level than, the domestic legal order. It should, moreover, be noted that the prevalence of international agreements over national law is also set forth in article 27 of the Vienna Convention on the Law of Treaties of 23 May 1969.

On the other hand, Belgium is of the view that treaty provisions do not affect domestic law. If the right to tax has been assigned to Belgium pursuant to a DTC, this does not necessarily mean that Belgium will effectuate its taxing rights. Indeed, a DTC does not create or introduce any tax liability. If Belgium wishes to tax in a specific case, the threshold under national law should be satisfied (here, the presence of a BE) and the tax must be levied in accordance with national law.

In this sense, the impact of a DTC is limited to restrictive and relative effects. In this respect, the Court of Cassation has ruled that DTCs "do not govern the basis of assessment, but only exempt certain profits from taxation".

The above-mentioned conclusions should undoubtedly be tempered somewhat. In our opinion, numerous DTC provisions have indeed more than just a restrictive effect. Undeniably, DTCs contain material provisions, such as those that actually regulate (e.g. the mutual agreement procedure, the exchange of information procedure, the non-discrimination clause, etc.). The imperative character of these provisions leads to the full functioning of the principle of treaty prevalence so that domestic law is sidelined insofar as necessary for the treaty to apply. Certain treaty provisions, on the other hand, extend domestic law in that they allow taxpayers to qualify for rights which they normally would not enjoy under national law (e.g. they provide for a tax credit with respect to withholding taxes, although this is not, or only in a limited manner, provided for under national law). Finally, DTCs also contain so-called "remedial provisions", i.e. provisions adjusting national tax law as regards the tax technique and assessment basis. One clear example is the attribution of a PE's profits (article 7 OECD MTC).

As a rule, the reporter believes that these three categories of treaty provisions should be deemed self-executing, i.e. they prevail over national law and are enforceable without the need for implementing national legislation.

3.3. The general approach to the allocation of profits to a Belgian PE under the DTCs

The allocation of profits to a PE under the DTCs reveals major similarities with Belgian tax law. Below we systematically examine the extent to which the DTCs accept (or provide an exception to) Belgian law.

First, it should be noted that the OECD MTC and most of the DTCs concluded by Belgium explicitly reject the force of attraction principle. In this respect, the administrative commentary to the DTCs clearly states that the presence of a PE does not entail the extension of the source state's right to tax to the profits the company realized in that state without the assistance of its PE. Specifically, this means that no profit can be allocated to the PE for transactions that the company coordinates from its foreign head office and carries out in the source state without the involvement of the PE.

Nevertheless, a few DTCs concluded by Belgium recognize a limited force of attraction principle. However, the protocols to these DTCs clarify that, in order for the PE to have an attractive force, (a) the PE should have been instrumental in or contributed to the transactions in question on a regular basis or (b) proof should be provided that tax avoidance was the purpose of the foreign company.

In principle, Belgian DTCs opt for the direct method to attribute profits. This technique starts from the personification of the PE for tax purposes. As under Belgian law, the PE is deemed to be an imaginary independent company (the independence fiction) meaning that profits are attributed to the PE as if it had been dealing with an independent third party, rather than its head office, under the same or similar circumstances.

In the treaty context, an express reference to the independence fiction can be found in article 7(2) of the OECD MTC; an almost identical provision can be found in all DTCs concluded by Belgium. In the reporter's opinion, the wording of this provision makes clear that when assessing the profits of a PE, it should be presumed to be absolutely independent; therefore, an absolute independence fiction should be the basic assumption. This implies that (a) interest, royalties or rent paid by a PE to its head office should be deductible for tax purposes in the hands of the PE and (b) transfers of goods between a PE and its foreign head office should be valued at arm's length. To date, the Belgian tax authorities seem to be sympathetic to this position as regards transactions listed under point (b) (see section 3.5.1 below). As regards the payments referred to under point (a), however, the tax authorities support limited independence of the PE and thus reject the deductibility in the hands of the PE. An exception to this is only made for financial institutions.

Article 7(2) contains the basic rule for the attribution of profits to a PE. In principle, the Belgian tax authorities will adhere to the financial accounts of the PE. However, if an abnormal shift in profits to the head office (or vice versa) is found, a readjustment can be executed. In this context it is irrelevant whether the artificial profit shifting occurred deliberately. Therefore, the tax authorities can assess each individual operation, apply the arm's length principle, and correct each operation as appropriate until the correct arm's length level is reached (they must take into account, however, the specific characteristics of the group and its pricing policy).

It follows from the assimilation of a PE with an independent company that, still within the scope of the direct method, it is also possible to assess a PE's profits on the basis of methods provided for under national law. Thus, the comparison method can be used for PEs established in Belgium (see section 2.2 above), provided regular accounts or other evidentiary information that would enable an assessment of the PE's profits are not available. Application of the comparison method is, however, not optional; if no accounts or other probative documents are at hand, the comparison method is compulsory. In this way, the treaties confirm the conditions mentioned in article 342 ITC. Where appropriate, a flat-rate assessment may also be applied in accordance with article 182 RD/ITC. The tax authorities, however, have specified that application of this method is limited to cases where it is obvious that it is impossible to assess the PE's profits on a more suitable basis.

Finally, DTCs do not exclude the possibility of assessing the profits of a PE in accordance with other methods provided for under domestic law. In this respect, Belgian tax law refers to methods that rely on presumptions, on the one hand, and signs or indications, on the other.

By way of derogation from the foregoing, certain Belgian DTCs allow profits to be assessed in accordance with the profit-splitting method, at least if this method is customary in a given country. This method consists of attributing the company's total profits to its various parts by using a particular formula and is a clear exception to the principle that the PE must be considered an independent company for tax purposes.

The Belgian tax authorities are of the opinion that this method should be avoided as much as possible since its results are inaccurate by definition. It is therefore doubtful whether the profit-splitting method can be used at all under Belgian law if probative accounts are available. Nevertheless, the tax authorities seem to accept application of this method if the head office and the PE pursue similar activities and no other method for assessing profits can be applied; furthermore, it is also believed to be the proper method for insurance companies.

Obviously, the profit-splitting method is inferior to the direct method. Not only must it be an accepted method in one of the contracting states (which is not the case for Belgium), but it can only be applied insofar as the end result is consistent with the principles set forth in article 7 of the OECD MTC.

As regards costs and expenses, it should be remembered that under Belgian tax law only costs and expenses which are specifically linked to the BE are tax deductible. Therefore, only costs the BE incurred itself as well as those borne by the head office for the purpose of the head office and that are exclusively attributable to the BE may be deducted. Overhead costs, including management and administrative expenses (except for general advertising costs), are disallowed (see section 2.2 above).

The Belgian DTCs, however, contain an exception to the above rule. A proportionate share of the overhead costs may indeed be deducted from the PE's profits if proof is provided that these costs also benefited the PE. This exception derives directly from article 7(3) of the DTCs.

The share of overhead that can be allocated to a PE should be determined in accordance with the profits attributable to the PE. If such an allocation cannot be made with a sufficient degree of accuracy, the tax authorities will accept application of a formula. Furthermore, it is generally accepted that the allocation of the overhead costs should not occur with a mark-up and should not depend on effective reimbursement by the PE to its head office. However, in order to be deductible, the share of overhead attributable to the Belgian PE should meet the conditions set forth in the ITC with regard to business expenses (articles 49 *et seq*. ITC); as the case may be, an adjustment may need to be made.

As regards the PE's own costs, it should be reiterated that also at the level of the DTCs Belgium does not accept the deductibility of interest, royalties and rent paid by a PE to its head office. An exception is only available for financial institutions (see above).

A final question to be addressed is whether the Belgian PE may allocate a share of its profits to the foreign head office in return for good management (a so-called *praecipuum*). This question should be answered in the negative. Indeed, the Belgian tax authorities, following the OECD commentary, take the position that such fictive remuneration cannot be allowed as a deductible expense in the hands of the PE. In the same line of reasoning, Belgium apparently does not require in the opposite situation (Belgian head office with foreign PE) that such remuneration be added to the profits of the Belgian head office.

Finally, and contrary to Belgian tax law, it should be noted that according to Belgium's DTCs it is not allowed to attribute profits to a PE for mere purchases. This rule is based on article 7(5) of the OECD MTC and thus takes precedence over domestic law. It is interpreted narrowly, however, in that profits can still be attributed to the purchase activities if the PE uses the purchased goods for operations such as sales, processing or manufacturing (i.e. for the benefit of the head office) or on behalf of a third party (e.g. an affiliate).

Provided no profit can be attributed to the PE on the basis of mere purchases, it follows that the related expenses cannot be deemed business expenses and therefore cannot be deducted from the profit realized by the PE through other operations.

3.4. The general approach to the attribution of profits to a foreign PE under the DTCs

Pursuant to the Belgian DTCs, Belgium will provide for a tax exemption for the profits of the Belgian company that are taxable in the PE state. The foreign PE's profits are fully exempt without progression, i.e. these profits are not taken into account in computing the tax due by the Belgian head office. This is a direct consequence of the Belgian tax assessment technique. As a rule, the exemption is available regardless of whether the profits were effectively subject to tax abroad. Nevertheless, a number of treaties derogate from this rule and provide that the exemption is only available if the profits were actually subject to tax in the source state.

The amount of foreign-source profits exempt from tax in Belgium must be assessed on the basis of Belgian tax law. In practice, this means that the PE's net book result will be used as a starting point to which any necessary adjustments will be made afterwards. Stated otherwise, Belgium will give relief only for the net profit of the foreign PE as far as this is assessed in accordance with Belgian law and after deduction of taxes paid or due abroad.

There has been a protracted debate in Belgium about the exact meaning of the term "exemption". This debate came to the fore in the case of a loss-making Belgian head office with a profitable foreign PE. According to the Court of Cassation, from a tax technical point of view, treaty exemption did not prevent the PE's profits from being initially included in the company's gross taxable basis for CIT purposes (cf. article 185(1) ITC), implying that the exempt profits were in fact deducted from Belgian losses. As a result, any tax savings from the loss deduction (in following years) was lost. After all, the deduction of exempt profits does not result in any tax savings. In this way, the exempt foreign profits were subject to tax in Belgium again. This position was dubbed the *Velasquez* theory, after the Court's first judgment in which it was adopted. In the meantime, however, the European Court of Justice ruled that this theory is inconsistent with European law.

Virtually all of Belgium's DTCs include a "recapture rule" for PE profits. If this provision is applied, profits realized by the foreign PE will not be exempt to the extent that foreign losses have been deducted both in Belgium and abroad.

3.5. The attribution of profits under the DTCs in the case of internal dealings

3.5.1. General remarks

There is little to go on in the Belgian administrative commentary or the jurisprudence on the interaction between Belgian tax law and the DTCs in the case of intra-company dealings. Therefore, reference should be made to the general principles on the application of article 7(2) of the OECD MTC.

The initial conclusion is that an assessment of profits only arises in the case of actual dealings between a head office and its PE. Consequently, if goods are transferred to a PE for temporary use in the PE – implying that the goods cannot be deemed to have been permanently invested in the PE (see section 2.2 above) – the transfer can happen without mark-up. In that case, it seems appropriate that the PE using the goods should bear its share of the cost related to the goods in question, for instance a suitable share of the depreciation.

In the case of genuine intra-company dealings, the question arises as to whether article 7(2) of the DTCs requires that a transfer of goods and/or services should always occur under arm's length conditions, i.e. for a remuneration an independent company would have paid to a third party under the same circumstances. Some commentators argue that article 7(2) simply introduces a limited independence fiction. Read in conjunction with article 7(1), they conclude that only profits actually realized can be attributed to a PE and/or the head office. Therefore, if there are no profits on the whole – which will be the case as long as the goods are not sold outside the company (i.e. to a third party) – there can be no attribution of profits. However, the reporter cannot help but express serious doubts about this view. Certainly, in the light of recent developments within the OECD, it is appropriate to interpret article 7(2) more autonomously and to assume the complete independence of the PE.

A strict application of the independence fiction (absolute or complete independence) means that intra-company dealings should occur in accordance with the arm's length principle. Therefore, it may be necessary to attribute profits to a PE (for instance when the PE transfers goods to its head office), even if the company did not actually realize any profit. The DTCs contain no provisions to counter the conclusion that internal dealings between a PE and its head office (or vice versa) may be considered a sale in the transferor's country and thus subject to tax in that state.

On several occasions, the Belgian tax authorities seem to adhere to the theory of complete independence of the PE. It is indeed accepted in the administrative commentary to the DTCs that profits should be adjusted in accordance with article 7(2) if there has been an artificial shift in profits due to non-arm's length dealings between a Belgian PE and its foreign head office. If recognition of profits were based on the personification of the PE for tax purposes in this case, the same principle would have to be applied, in the reporter's opinion, in the reverse situation as well.

The Belgian tax authorities also recognize the complete independence of a Belgian PE with respect to services it provides to its foreign head office. In our opinion, however, there seems to be no legitimate reason to limit the fiscal personification of the PE to services; rather, it should apply to all internal dealings.

As regards the time at which profits ought to be realized in the case of internal dealings, reference should be made to national law (see above). If double taxation arises due to differences between national laws with respect to the timing issue, the residence state of the head office should work together with the PE state (mutual agreement procedure) to solve the problem on a case-by-case basis.

3.5.2. The transfer of inventory

3.5.2.1. From a Belgian head office to a foreign PE

Pursuant to article 7(2) of the DTCs, the arm's length principle should be respected in this hypothesis.

3.5.2.2. From a foreign PE to its Belgian head office

Under Belgian law, such a transfer gives rise to a realization of profits attributable to the PE. These profits are exempt from tax in Belgium on the basis of the applicable DTC.

3.5.2.3. From a Belgian PE to its foreign head office

Pursuant to article 7(2), the arm's length principle should prevail when inventory is transferred from a Belgian PE to its foreign head office. This transfer should therefore occur at market value and should result in a realization of profit. If necessary, the PE's declared profit may need to be corrected and adjusted.

3.5.2.4. From a foreign head office to a Belgian PE

Logically, the arm's length principle should be applicable in this situation too. An artificial shift of profits abroad should be avoided, meaning that the market value may not be exceeded.

3.5.3. The transfer of tangible fixed assets

The same conclusions apply here as under section 3.5.2 above.

3.5.4. The tansfer of intangible fixed assets

Insofar as only a right to use an intangible fixed asset is granted, it is worth repeating that the Belgian tax authorities, in the reporter's opinion erroneously, support a restricted independence fiction. Therefore, as a rule, internal royalty flows are not acknowledged. The fact that a Belgian head office and/or Belgian PE grants a right of use is therefore not a taxable event. Conversely, if the foreign PE grants a right of use to its Belgian head office, Belgium will not exempt the profits (whether or not notional) that may have been subjected to tax in the PE state.

For a final transfer of intangible fixed assets, see section 3.5.2 above.

3.5.5. The provision of services

The arm's length principle should be applied upon the internal supply of services that involve the company's core business. Therefore, the same conclusions as under section 3.5.2 above are applicable.

However, if a Belgian PE incidentally provides supporting or auxiliary services to its head office within the meaning of article 5(3) of the OECD MTC, the related expenses should be attributed to the head office. These expenses should be allocated on a historic cost basis, i.e. without any mark-up.

As regards services that fit into the Belgian or foreign head office's general management of the company as a whole, it is worth recalling that an appropriate share can be allocated to the PE pursuant to article 7(3) (see section 3.3 above).

3.5.6. The allocation of capital to a PE

In fact, correct application of the arm's length principle presupposes that capital would be attributed to the PE for tax purposes. This capital should be sufficient to finance the PE's activities and any assets it uses and risk it bears. The significance of such capital is obvious: to avoid the PE being financed entirely by debt and claiming higher interest deductions. As soon as an arm's length capital is fixed, a comparison should be made with the actual amount of capital attributed to the PE and adjustments should be made, if necessary.

To the best of our knowledge, the Belgian tax authorities to date do not follow this line of reasoning.

3.6. The assessment of the profits of an agency PE

The reporter believes an arm's length remuneration presupposes that the PE is actually compensated for the activities it performs – assessed on the basis of a functional analysis (e.g. a supporting or sales role) and taking into account the assets used (e.g. a trade name) and the risks borne (e.g. doubtful debts) – and for the value it adds to the company as a whole. Accordingly, not only the agent's performance as such should be compensated; we believe also a share of the sale proceeds should be attributed to the PE. Please note, however, that some DTCs exclude such extensive attribution of profits. Indeed, the protocols to these treaties explicitly assume that the PE's profits should be assessed exclusively on the basis of its actual share in the company's profit attributable to the PE's real activities re the sales or commercial transactions.

4. The future

The Belgian tax authorities have yet to undertake an extensive study or implementation of the OECD discussion drafts on the attribution of profits to PEs. For the time being, it is mere speculation to try to predict the tax authorities' position. It will probably come close to the OECD guidelines, i.e. a strict interpretation of the independence fiction is expected. In this respect, it should be noted that over the years the Belgian tax authorities have endorsed the independence fiction in many respects. The introduction of article 185(2) ITC in Belgian tax law confirms and strengthens this position. It now looks as if only a limited number of implications stemming from the independence fiction (such as internal interest payments and royalty flows, a minimum capital requirement for PEs, etc.) are waiting to be introduced.

The OECD draft report states that the proposed guidelines re the application of article 7 of the OECD MTC in no way conflict with either its original intent or with the historical practice and interpretation of article 7. It is, however, assumed that the OECD commentary, once the report is finalized, might be changed for purposes of clarification. Any such changes should be viewed against the backdrop of the OECD Committee on Fiscal Affairs' position that the commentary, like the convention itself, should be interpreted as a developing document.

The question, however, remains as to whether the Belgian courts must consider the new guidelines and/or adjustments introduced by the OECD commentary in implementing and interpreting DTCs based on a previous version of the commentary. In the reporter's opinion, it is important to proceed with caution. If a DTC requires interpretation, as a rule only the commentary as it exists (or existed) at the time of signing the DTC should be considered. After all, the treaty negotiations are based on this commentary and have resulted in a balanced outcome for all parties involved. The new guidelines, to the extent that they do not contain linguistic clarifications or specifications of a concept or provision in the convention but rather involve a fundamental modification of the commentary or the DTC itself, could upset this fine balance. In such a case, it seems inappropriate to interpret the modifications broadly. The basic assumption is indeed that the Belgian courts should be guided by the (initial) intent of the contracting states.

On the other hand, Belgium ought to disclose its position for the sake of principles such as legal security and international courtesy. One way of doing so would be to make a reservation on the retroactive effect of specific amendments in article 7 of the OECD commentary. If not, it would be reasonable to assume *ex tunc* approval of the amendments/clarifications.