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# Coordination centres make Belgium the market leader

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*Jon Meyers and Peter Verhaeghe of Cleary, Gottlieb, Steen & Hamilton summarise the key factors that make Belgian "coordination centres" a leader in the European market of low-tax vehicles for group finance and headquarters functions*

Belgium is all but a tax haven. But special legislation was enacted almost 10 years ago offering very generous tax breaks to so-called "coordination centres", a form of headquarters operations for multinational corporate groups. These tax concessions, reminiscent of more tropical places, have helped to attract a significant number of such operations to Brussels, Belgium's capital and, conveniently, the Washington DC of the European Community. About 300 coordination centres have been licensed to date. The list includes General Motors, IBM, Siemens, Caterpillar, Volkswagen, Nestlé, Exxon, Pioneer, Procter & Gamble, Honda and Coca-Cola.

Belgian coordination centres are the leader in the European market of low-tax structures for group finance and support functions. In comparing potential locations and vehicles, there is no universally correct choice. It remains a facts and circumstances question to a very significant degree. But a Belgian coordination centre, should almost always be on the planner's short list. Purely in tax terms, it offers a superior solution in many cases. Its edge derives from the combination of very low Belgian taxation (including quasi-exemption of interest income) and the wide spectrum of permissible intra-group financial and support services. These pluses usual-

ly outweigh the minuses. One of the minuses, in the eyes of many, is a local employment requirement.

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## Basic Belgian tax treatment

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Let us first outline the Belgian tax treatment and then look briefly at some foreign tax aspects. The Belgian tax benefits do not vest automatically but require the prior licensing of the coordination centre by the authorities. This licence is valid for a (renewable) term of 10 years. It may be revoked if the centre fails to meet certain continuing eligibility conditions (described on page 9).

A coordination centre is subject to Belgian corporation tax at the ordinary rate (currently 39 per cent for resident corporations and non-resident corporations from most treaty countries). But this tax is levied not on the centre's actual income but on a notional income that generally bears little or no relationship to earnings and profits in an accounting sense. That notional income is, as a rule, defined as a certain percentage of the centre's overheads. Specifically, it is determined by taking the percentage mark-up over costs charged by the centre itself (typically 8 per cent or thereabouts) and applying it to all the centre's costs other than payroll expenses and financial charges. Take a coordination centre which bills out its (non-financial) services on a cost-plus-8 per cent basis, incurs total costs in a given fiscal year of BF100 million of which BF80 million are payroll expenses and financial charges, and has accounting profits for the same year of BF25million (partly because of interest income on loans and treasury investments from share capital funds). That centre would in principle be taxed only on a notional income equal

to 8 per cent of BF20 million or BF1.6 million. Its income tax liability would be 39 per cent of BF1.6 million or BF 624,000 which would represent an effective tax on actual income of only about 2.5 per cent.

However, the general rule just summarised is qualified by a peculiarly structured anti-abuse provision. Pursuant to this provision, a coordination centre is taxed on the higher of (i) the notional income as defined above and (ii) the aggregate gross amount of disallowed expenses and excess profits derived from intercompany charges that do not satisfy the arm's-length standard. This alternative minimum tax of sorts is intended in part to discourage artificial profit shifting to coordination centres. A coordination centre cannot claim any tax deductions or loss relief under normal rules. It is, however, allowed a foreign tax credit (*quotité forfaitaire d'impôt étranger*) for foreign withholding tax on interest payments to the centre. But a coordination centre may not get full mileage out of this, as any excess of this credit over the centre's (usually limited) income tax liability is neither refundable nor eligible for carry-over.

Significantly, dividends paid by coordination centres are exempt from Belgian withholding tax, irrespective of the country of residence of the shareholder or the size or duration of its shareholding in the centre. A centre's interest payments are also exempt from (10 per cent) withholding tax except if made to Belgian resident individuals or not-for-profit organisations. Other tax benefits include a withholding tax exemption for interest from deposits with Belgian banks (including local branches of foreign banks), zero capital duty (instead of 0.5 per cent) on contributions to the share capital of coordination centres, and an exemption from the tax prepayments for deemed income from real property (*précompte immobilier*). In existing literature on coordination centres, one is likely to find more or less extensive discussion of a special tax credit (referred to as "fictitious withholding tax" or more aptly "deemed-paid withholding tax credit") granted on the financing of new investments in Belgium via a coordi-

nation centre. A recent act of Parliament, however, has (temporarily?) repealed that credit for future investments (more specifically, for project financing not already in place before July 24, 1991).

The Belgian approach to the taxation of coordination centres goes way beyond the concern to avoid economic double taxation that underlies the more conventional form of tax relief for intra-group financial and headquarters-type support services. The classic relief essentially consists of a safe-harbour ruling in respect of the pricing of such services. The basic concept here is that the tax authorities of the country in which the centre is established undertake not to make upward adjustments to the centre's income as long as some specified minimum level of income is reported. The purpose is to alleviate exposure to economic double taxation resulting from the centre's jurisdiction requiring a higher level of remuneration than the beneficiaries of the services are allowed to deduct in other jurisdictions. But the Belgian approach totally disassociates taxable income from earnings and profits in an accounting sense: it disregards actual income and taxes a deemed margin over costs but without counting two key items, ie payroll expenses and financial charges. This creates opportunities for tax savings and/or tax deferral.

In broad outline, tax savings on a consolidated basis arise where the value of tax deductions for service fees or interest exceeds the total tax burden on the corresponding income elsewhere in the group, taking into account subpart F-type anti-deferral rules and foreign tax credit limitations in the jurisdiction of the ultimate parent. A coordination centre's revenue attracts Belgian income tax only insofar as the activities that generate such revenue produce an increment in the overheads includible in the centre's taxable cost-base, ie its costs other than payroll expenses and financial charges. Thus, generally speaking, a coordination centre's potential for tax savings should be greatest for group financing and treasury management activities as well as other support services with a high skilled-labour con-

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tent. In particular, interest income may, in many cases, flow through a coordination centre substantially free from Belgian tax. There are many variations on the basic theme of equity-funded lending by coordination centres aimed at producing interest deductions in high-tax jurisdictions and corresponding lower-tax dividend income elsewhere.

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### Foreign tax considerations

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Coordination centres (at least those organised as separate Belgian corporations and not as branches of foreign corporations) should, in principle, have access to Belgium's network of over 40 tax treaties, occasional argument to the contrary notwithstanding. None of these treaties specifically excludes coordination centres. More general limitation-on-benefits (anti-treaty shopping) provisions are absent from most Belgian treaties. But article 22(1) of the Belgian-Swiss treaty and, especially, the new article 12A of the Belgian-US treaty may require consideration. The latter clause may be relevant for coordination centres controlled by third-country interests and/or owing significant interest payments to third-country residents. These centres may depend on an "active business" test for entitlement to the benefits of the Belgian-US treaty. But in many cases tax treaty protection is not as critical for coordination centres as one might think. A coordination centre may occasionally need the treaty interest article for an exemption from, or reduction of, foreign withholding tax on interest payments to the centre. The dividend article, however, is irrelevant, as a coordination centre may not hold shares. Likewise, the working assumption should be that a coordination centre cannot engage in the licensing of intellectual properties. Accordingly, the significance of the royalty article would be limited to a coordination centre's cross-border lease financing activities (if any).

Various complexities arise in the interaction with the tax laws and practices in the jurisdictions of the recipients of the centre's services and that

of the parent company. There remain differences in attitude among national tax authorities about the proper pricing of intra-group coordination and support services. The matter requires careful analysis, with close attention to the parameters set out in the 1979 and 1984 OECD reports on the subject. Another constraint comes from subpart F-type anti-deferral rules that may exist in the jurisdiction of the parent. The US and UK rules in particular place severe limitations on a coordination centre's potential for tax deferral. But while those rules may eliminate tax deferral, they do not necessarily destroy opportunities for tax savings. Exemption jurisdictions like the Netherlands, on the other hand, have to deal with an issue of "double non-taxation" created by the very low taxation of a coordination centre's earnings and profits in Belgium. There have been suggestions in recent months that the Dutch authorities are considering denying the participation exemption for dividends from coordination centres in certain circumstances. But the EC Parent-Subsidiary Directive does not leave much room for this.

US-based groups account for an important number of coordination centres, ever tighter subpart F provisions notwithstanding. The US tax reforms of the mid-1980s have not visibly diminished their interest in this vehicle. On balance, these reforms have not detracted from, and may even have enhanced, the potential tax benefits offered by a Belgian coordination centre. The comparatively low rate of US federal corporate income tax and the added restrictions on the creditability of foreign taxes have increased pressure on US groups to reduce the foreign tax burden on their overseas operations. A Belgian coordination centre may provide tax saving opportunities in this respect. For example, administrative and other support services for non-US affiliates may usefully be assigned to a coordination centre as part of a strategy to diminish foreign taxes. The tax deductions for the fees paid by those affiliates, combined with the very low taxation of the centre's fee income in Belgium, should result in a reduction of the total non-

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US tax burden borne by the group worldwide. Moreover, when the centre's fee income is divided up to the US parent (or otherwise becomes subject to US tax), that income should, under the "look-through" rules, be included with operating income from other foreign affiliates in the residual "basket" for foreign tax credit purposes. Thus, the use of a coordination centre may alleviate foreign tax credit problems of the US parent by reducing the level of foreign taxes without effecting a corresponding reduction in foreign-source taxable income used to compute the maximum allowable foreign tax credit.

### Spectrum of possible activities

The activities of a coordination centre must remain limited to those specifically included in its licence. But the licensable activities cover an array of intra-group financial services and headquarters-type coordination and back office support functions. The broad spectrum of possible activities in the financial area in particular is one of the unique features of Belgian coordination centre legislation. Indeed, a coordination centre may substantially fulfil the functions of an in-house banker towards the operating companies of the group. Activities in this sphere include inter alia:

- Classical intra-group lending;
- Lease financing (not operating leasing) of personal and real property;
- Factoring of group members' receivables;
- Re invoicing in respect of intercompany product flows and services;
- Multilateral netting of intercompany payables and receivables;
- Currency hedging transactions;
- Centralised monitoring and investment of group members' cash resources.

The law and administrative practice place a number of – sometimes very subtle – limitations on the permissible activities of coordination centres. Only a few of them can be mentioned here. A key restriction is that a coordination centre may render services only to affiliates, ie in broad outline, corporations of which the group's parent

holds, directly or indirectly, 20 per cent or more of the stock (by vote or value). No services may, however, be rendered to affiliates which are themselves in the financial business (banks, insurance companies, leasing companies and the like). Administrative practice is hostile to the idea of a coordination centre engaging in captive (re)insurance (although it may be authorised to fulfill a good part of the functions of a captive broker). Also, the working assumption should be that a coordination centre cannot serve as a vehicle for intra-group licensing of intellectual properties.

Coordination centres may issue debt securities but special restrictions apply for paper with a maturity of more than one year. Centres that want to issue such paper need special (but routinely granted) governmental authorisation. Furthermore, the securities in question may not be denominated in Belgian francs and must be placed outside Belgium under selling restrictions targeted at Belgian resident individuals and not-for-profit organisations. As a practical matter, the local employment requirement discussed below makes a coordination centre unsuitable to serve as a one-off vehicle for issuing debt.

Another restriction, introduced last summer, concerns a coordination centre's activities in the area of treasury management. It essentially prohibits a coordination centre from using its share capital funds for cash investments outside the group insofar as those capital funds have themselves been funded by debt that gives rise to interest deductions in Belgium. This prohibition is confined to the relatively narrow fact pattern in which an affiliate takes out a loan, deducts the related interest payments in Belgium and drops down the loan proceeds as share capital in a coordination centre (possibly via one or several tiers of intermediate corporations), which in turn uses the cash for passive investments generating tax-free interest income.

A coordination centre cannot itself serve as a holding company. The law specifically provides that coordination centres may not hold any shares in other companies, without distinguishing between related and unrelated

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companies or between active participations and mere portfolio investments. But a coordination centre could do much of the related financial and backoffice work (auditing of accounts, reporting, corporate paperwork, tax planning and the like). Thus, it could usefully be teamed up with a separate Belgian affiliate that would serve as a regional holding company (and perhaps perform certain other headquarters functions not authorised to the centre). A recent Belgian law, adopted in response to the EC Parent-Subsidiary Directive 90/435, makes Belgium a potentially very attractive location for European holding companies. Relevant tax benefits include:

- A 95 per cent dividends received deduction (regardless of size or duration of the shareholding, but not for dividends from tax-haven sources);
- Exemption of gain on the disposition of the shares (but non-deductibility of capital losses on stock other than liquidation loss);
- And, in a potentially significant departure from, eg, applicable rules in the Netherlands, continued deductibility of interest on share acquisition indebtedness. (This is real competition for the Dutch holding company.)

**Eligibility conditions**

The principal conditions of eligibility for coordination centre status may be summarised as follows. First, the corporate group in question may not (predominantly) be a banking or insurance group and must meet certain tests as to size and multi-country composition. Thus, that group must have:

- Consolidated share capital and surplus reserves of at least BF1 billion (\$30 million), of which at least BF 500 million or 20 per cent, whichever is less, must be attributable to affiliates outside the home country of the group parent;
- Consolidated annual turnover of at least BF 10 billion, of which at least the lesser of BF 5 billion or 20 per cent must be realised outside the parent's country;
- At least one subsidiary in at least four different countries other than the parent's country, uninterrupted since

January 1 of the second year preceding that of the application for a coordination centre licence.

Second, coordination centre status is subject to a local employment requirement. Specifically, the tax benefits "vest" only if the centre employs in Belgium "the equivalent of at least 10 full-time employees" on the second anniversary of the date on which it commenced its activities. The centre must subsequently maintain its local staffing at at least this level in order not to forfeit its tax-favoured status. Employees transferred from a Belgian affiliate may be counted if replaced there. There are no restrictions on nationality and staff assigned from abroad should fully count. But the Belgian Department of Labour seems prepared to count only employees who are or become subject to Belgian social security (irrespective of EC or bilateral treaty exemptions) – an extra-statutory condition which may not withstand judicial review.

Third, as already suggested, coordination centre status is also subject to a licensing requirement. A reasonably detailed application is to be submitted to the government and the licence is ordinarily issued three to five months later. If granted, it retroacts to the beginning of the fiscal year in which the application was filed.

There are no special conditions on the corporate form, capitalisation or share ownership of a coordination centre. A coordination centre may be organised either as a separate Belgian corporation or as a Belgian branch of a foreign corporation. The vast majority of centres have been set up as separate subsidiaries, mostly in the form of a stock corporation (*société anonyme*). The choice of another corporate form may be considered in certain cases (eg, to achieve partnership characterisation in another jurisdiction). The stock of the coordination centre need not be held directly by the ultimate parent company of the group but may be owned by other group members. Income access share structures (including "parts bénéficiaires") could be used to direct dividend streams from the centre to particular destinations in the group as appropriate. ●