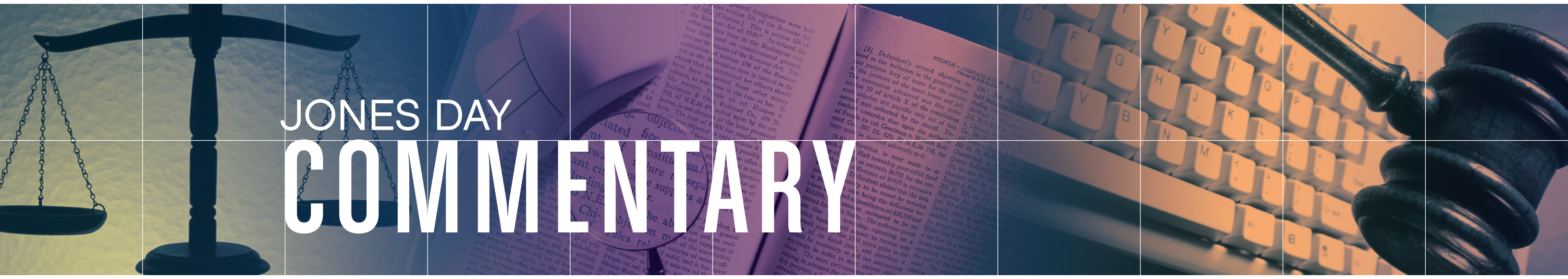
JULY 2005



INTERNATIONAL TAX PLANNING

BELGIUM IS TAKING STEPS TO ENHANCE ITS ATTRACTIVENESS

Belgium has long been considered an interesting jurisdiction for various tax-planning and structuring purposes. Capital gains on shares are normally tax-exempt, dividends can be received nearly tax-free, interest paid on loans taken out to acquire shares is still tax-deductible, and Belgium has had a very favorable tax system in place for companies with headquarters-type activities—the so-called coordination center regime.

Unfortunately, under pressure from the European Union, the coordination center regime has recently been revised, and it may even be repealed entirely. In addition, the expansion of the EU to countries with lower corporate tax rates, such as Cyprus, Latvia, Lithuania, and Hungary, has emphasized the need for Belgium to strengthen its position on the international tax map.

THE DEDUCTION OF NOTIONAL INTEREST

In response to these pressures, the Belgian government has introduced a new tax measure—the notional interest deduction, also termed a deduction for risk capital. The purpose of this measure is to remedy, at least partially, the existing distortion (for tax purposes) between the capital contributed and the money lent to a company by its shareholders. Specifically, from a tax perspective, companies traditionally have preferred to be financed by debt rather than by equity, as interest payments arising from loans are tax-deductible, whereas no deductible expenses arise from a company's capital.

Pursuant to this new measure, however, a Belgian resident company, as well as the Belgian branch of a foreign company, will be entitled to deduct from its profits a percentage of its adjusted net assets (see below) specifically linked to the rate of 10-year Belgian state bonds (3.236 percent as of June 2005). In other words, a qualifying Belgian investor/taxpayer may deduct 3.236 percent of its adjusted net assets from its annual profits. The deduction may be increased by half a percentage point for qualifying small and medium-sized enterprises. The precise percentage will be revised annually, but in principle, it may not vary by more than 1 percentage point from one tax year to another and may not exceed 6.5 percent in total. If the taxpayer does not earn enough taxable income for the notional interest deduction to be utilized in any one year, the remaining deduction may be carried forward for up to seven years.

The net assets to be taken into account when calculating the above-described deduction are those listed on the company's balance sheet at the end of the previous tax year—stated capital, share premium, reserves, etc. Some variations that appeared on the balance sheet during the course of the tax year in question may also be taken into account for this purpose. The net assets are then adjusted through the application of certain anti-abuse exclusions. For example, the net assets must be reduced by (i) the net value or tax bases of longer-term shareholdings held by the Belgian taxpayer (thus, failing to render Belgium more attractive for holding companies), and (ii) any net assets allocated to a foreign permanent establishment of the Belgian taxpayer located in a country with which Belgium has executed a double taxation convention (basically incentivizing Belgian investments, with one important exception discussed below).

Interestingly, the application of this new measure does not depend on the specific activities conducted by the taxpayer, nor is a formal ruling required in order to claim it.

On the other hand, this new measure does require an amount equal to the notional interest deduction to be booked as a liability on the balance sheet and blocked during the tax year in question as well as the three following years. It is this constraint that received the most criticism from corporate observers.

Notwithstanding this restrictive condition, the notional interest deduction may still offer some rather interesting tax planning opportunities, especially for highly capitalized entities. The latter should indeed see their tax bases substantially reduced, or even erased, as a result of this new measure. International groups will no doubt look favorably on this new possibility, especially because Belgium should become a credible alternative location for intragroup financing activities or other activities requiring a high level of financial resources, such as factoring or public procurement activities. This will work because financings and treasury operations, even if conducted with foreign persons (whether related to the Belgian company or not), will not engender a deduction from net assets and hence will benefit from the notional interest deduction.

As an illustration of its potential, this new measure could be used in the context of a "double-dip" construction, pursuant to which a parent company would borrow funds and contribute the amounts to the capital of a Belgian subsidiary, thereby allowing interest to be deducted twice: once at the level of the parent company and once at the level of the Belgian subsidiary. That said, any eventual structures must always be evaluated in light of the taxpayer's specific situation as well as anti-abuse measures in place in other jurisdictions.

This new measure was published in the *Belgian Official State Gazette* on June 30, 2005, and should be applicable beginning with the 2007 tax year, which includes accounting years ending on or between December 31, 2006, and December 30, 2007.

THE BELGIUM-HONG KONG INCOME TAX TREATY

Although this new measure is certainly the most interesting tax development to hit the Belgian scene in several years, the Belgian government has taken additional steps to increase the country's attractiveness for investors, such as eliminating the 0.5 percent capital duty on contributions made to a company's equity and, perhaps most remarkable, the execution of the new Belgium–Hong Kong Income Tax Treaty (the "Treaty"). The latter is especially interesting for investors, as it is currently the only tax treaty in force between a western country and Hong Kong.

In particular, the Treaty provides for a complete exemption from withholding tax on dividends paid to a beneficial owner that holds a direct participation of at least 25 percent in the distributing company for an uninterrupted period of at least one year. Otherwise, the Treaty allows the Contracting States to levy a withholding tax of 15 percent, or 5 percent if the beneficial owner directly holds at least 10 percent of the capital of the distributing entity.

Recently, the Belgian tax authorities issued a circular clarifying the application of the Treaty and confirming that dividends distributed by a Hong Kong entity to a Belgian holding company should, in principle, be entitled to the participation exemption in Belgium. Hence, 95 percent of any dividends received in Belgium will still be exempt from tax, even though no withholding will have been levied by Hong Kong, unless the Hong Kong company acts as a mere intermediary or conduit for tax-haven income.

Consequently, dividends paid by European subsidiaries to a Hong Kong parent company could avoid tax if paid through a Belgian vehicle, except for the nonexempt portion of 5 percent, which in any event can be offset by interest deductions if the European subsidiaries have been acquired or restructured in a leveraged fashion. Similarly, dividends paid by a Hong Kong company to its European parent company may be exempt from tax if paid through a Belgian vehicle (again, except for the nonexempt 5 percent portion of the dividends received). Of course, any such structure should be properly established on a case-by-case basis in order to meet the conditions of the EU Parent–Subsidiary Tax Directive and local tax laws in all jurisdictions concerned.

No doubt this Treaty, the first and, at present, the only one of its kind, will prove to be an opportunity for European or U.S. businesses to invest in Hong Kong—and Greater China—in a tax-efficient manner, and vice versa.

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In sum, Belgium has rejuvenated itself and must now be considered in any international tax-planning structure, especially as a financing center as well as a turntable with Asia.

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