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## Belgium:  A Gateway For Investment In Europe

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Belgium has long been considered as 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 are still tax-deductible, and last but not least, Belgium 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under pressure from the European Union, the coordination center regime has recently been revised (and may even be repealed entirely). In addition, the enlargement of the EU to countries with lower corporate tax rates (such as Cyprus, Latvia, Lithuania, and Hungary) has focused the need for Belgium to find a means to keep its privileged place on the international tax map.

### The Deduction of Notional Interest

In response, the Belgian Government has introduced a new tax measure, *i.e.*, 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 moneys lent to a company by its shareholders. Specifically, from a tax perspective, companies have traditionally had a preference 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 a 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 (currently, 3.526 percent as of May 2005). In other words, a qualifying Belgian investor/taxpayer may deduct 3.526 percent of its adjusted net assets from its annual profits. The deduction may be increased by another 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, in any case, it 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 for purposes of calculating the above-described deduction are the net assets (*e.g.*, stated capital, share premium, reserves, etc.) as per the balance sheet of the company at the end of the previous tax year (some variations in the balance sheet during the course of the tax year in question may nevertheless be taken into account for this purpose). The net assets are then to be adjusted by applying 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, this measure does not 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 conversion (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 that an amount equal to the notional interest deduction be booked as a liability on the balance sheet, and blocked during the tax year in question and the three following years. This constraint has been the most criticized by 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 base substantially reduced, or even erased, as a result of this new measure. International groups will no doubt look favorably on this new possibility, especially as Belgium should become a credible alternative location for intra-group financing activities or other activities requiring a high level of financial resources (*e.g*, 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 be deducted from net assets and hence will qualify for 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, *i.e.*, once at the level of the parent company and once at the level of the Belgian subsidiary. That being said, any eventual structures must always be evaluated in the light of the taxpayer's specific situation as well as anti-abuse measures in place in other jurisdictions.

This new measure has been published in the *Belgian Official State Gazette* on June 30, 2005, and should be applicable as from the 2007 tax year (which includes accounting years ending on or between December, 31 2006 and 30 December 2007).

## The Belgium-Hong Kong Income Tax Treaty

Although this new measure is certainly the most interesting tax development to hit Belgium over the past several years, the Belgian Government has also taken other steps to increase the country's attractiveness for investors, such as eliminating the 0.5-percent capital duty on contributions to the equity of a company, 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 which 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 holds directly at least 10 percent of the capital of the distributing entity).

Recently, the Belgian tax authorities have 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 non-exempt portion of five-percent, which can in any event 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 non-exempt five-percent portion of the dividends received). Any such structure should of course 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.

## Further Information

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