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FEATURED PERSPECTIVES

Belgium's Dividends Received Deduction Under Fire (Again)

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The Court of Appeal of Antwerp on April 28, 2009, issued a remarkable ruling in connection with the application of Belgium's dividends received deduction (DRD). This ruling means yet another blow for the current version of the Belgian DRD regime. Together with the ruling of the European Court of Justice in *Cobelfret* (case C-138/07 of February 12, 2009) and the ECJ's ''reasoned order'' in *KBC et al.* (joint cases C-439/07 and C-499/07 of June 4, 2009), the ruling makes clear that Belgium's DRD regime urgently needs an overhaul to make it compliant with EU regulations.

Relevant Facts

For book year 1999, J. Belgium CVA, a Belgian corporation (the taxpayer):

- received an interest-free loan from its (indirect) shareholder and manager, Mr. J.;
- earned fees for services allegedly rendered by the taxpayer to a related Dutch corporation (JPV BV); and
- received dividends from a qualifying participation established in an EU jurisdiction other than Belgium.

The taxpayer claimed a deduction of 95 percent of the qualifying dividends from its net income, based on the Belgian DRD regime in combination with the EU parent-subsidiary directive.

Position of the Belgian Tax Administration

The Belgian state maintained that the taxpayer was not entitled to the 95 percent DRD on dividends received, to the extent that the taxpayer's net income consisted of two ''not at arm's-length'' income elements, that is:

- the interest that the taxpayer — under arm's-length principles — should have incurred (but did not actually owe) on the loan extended by Mr. J.; and
- the fees earned from JPV BV, for which the tax authority claimed that the taxpayer had not performed services of any actual value.

Tax Provision at Stake

Although the Belgian tax administration had initially based its position on a different provision of the Belgian Income Tax Code (BITC), before the court of appeal it relied on articles 207 *jo.* 79 BITC. According to these provisions, a Belgian corporate taxpayer is not entitled to some tax deductions (including, but not limited to, the DRD) insofar as the taxpayer's net income consists of non-arm's-length income elements received from a related enterprise. The rationale behind this provision is to prevent artificial income shifting from one enterprise, which is — for a given tax year — in a tax-paying position, toward another (Belgian) corporate taxpayer, which has sufficient tax deductions for the same tax year so as to offset the artificially earned income.

The DRD is one of several tax deductions that a Belgian corporation can use to mitigate effective corporation tax on its net income; other tax deductions that may achieve the same result include net operating losses, current or carried over investment deductions, and current or carried over notional interest deductions. If, for tax year x, taxpayer A earns taxable income and does not use any of the above tax deductions while taxpayer B (related to A) earns little or no taxable income for year x but takes more or less substantial tax deductions, A and B may be inclined to set up an artificial arrangement to siphon away taxable income from A to B so that A is no longer taxable on the artificially transferred portion of its income, while B is not effectively paying tax on that portion thanks to the availability of one or more tax deductions. Articles 207 and 79 BITC are designed to prevent this type of artificial profit shifting.

EU Parent-Subsidiary Directive

Article 4(1) of the directive provides that member states must give relief for qualifying dividends derived by a parent company in one member state from a participation in a subsidiary company of another member state. This relief can take the form of either an exemption of the dividends in the hands of the parent (article 4(1), first indent), or a tax credit for the parent company to make up for corporation tax paid by the subsidiary (article 4(1), second indent). Belgium has opted for the exemption method (article 4(1), first indent), whereby it allows the deduction by the Belgian parent of up to 95 percent of the qualifying dividend income received from the qualifying subsidiary. Other than the nonexemption of 5 percent of the qualifying dividend income, the directive does not explicitly allow any other moderation or reduction of the 95 percent exemption.

The question at stake is, therefore, whether Belgium can refuse all or part of the 95 percent exemption in the hands of a Belgian parent company, to curb the perceived abuse that could arise when a related group company of the parent artificially transfers taxable income to the parent so as to allow the parent to mitigate effective taxation thereon by applying the 95 percent exemption to qualifying dividends received from a subsidiary.

Court Ruling

Referring to the ECJ ruling in *Cobelfret*, the Antwerp Court of Appeal sided with the taxpayer, holding that article 4(1), first indent, of the directive does not allow Belgium to moderate the effect of the 95 percent exemption for qualifying dividends from an EU subsidiary. (For the ECJ judgment in *Cobelfret*, see *Doc 2009-3117* or *2009 WTD 28-17*.) Hence, Belgium cannot validly restrict the DRD to the extent that no exemption is granted for an amount equivalent to non-arm's-length benefits received by the parent company from one or more related enterprises. By disallowing (a portion of) the DRD, Belgium runs afoul of its obligation to exempt qualifying subsidiary dividends as dictated by the directive, the court said. Consequently, the Court of Appeal ordered the Belgian tax administration to alleviate its assessment of the taxpayer insofar as it disallows the 95 percent DRD for an amount equal to the non-arm's-length benefits earned by the parent from one or more related enterprises.

Observations

A first observation is that the Court of Appeal of Antwerp does not even consider referring the case to the ECJ for a preliminary ruling regarding the correct interpretation of article 4(1) of the directive. Instead, the Antwerp court boldly applies the ECJ's findings in *Cobelfret* to the case at hand and concludes that under no circumstance can Belgium legitimately restrict or moderate the 95 percent DRD. By doing so, the court seems to bypass article 1(2) of the directive, which allows member states to apply national or treaty-based provisions to curb either tax fraud or abuse. Admittedly, the taxpayer did not request that the court refer the case to the ECJ for a preliminary ruling. Neither did the Belgian state invoke article 1(2) of the directive to permit the moderation of the DRD under articles 207 *jo.* 79 BITC.

Another observation is that in the ECJ's reasoned order in the joint cases of *KBC et al.*, the ECJ seems to be tempering its own verdict in *Cobelfret*, in that it explicitly refers to articles 4(2), 4(3), and 1(2) of the directive as a possible basis for disallowing the full and unrestricted dividend relief prescribed by article 4(1) of the directive. (For a summary of the ECJ's reasoned order in *KBC et al.*, see *Doc 2009-18466* or *2009 WTD 156-27*.) See joint cases C-439/07 and C-499/07 at margin No. 36, handed down on June 4, 2009, several weeks following the ruling of the Antwerp Court of Appeal.

A third observation goes to the text of article 79 BITC. According to that provision, a benefit that is not at arm's length and granted to a Belgian enterprise (the taxpayer) cannot be offset by the latter against some listed tax deductions, provided that the benefit is *granted by an enterprise* related to the taxpayer. In the case at hand, the interest-free loan had been extended to the taxpayer by Mr. J., its manager and indirect shareholder, being a private individual. Under Belgian tax law, when a private individual is a manager of a company, he is not (automatically) categorized as an enterprise/entrepreneur for tax purposes. In articles 24 through 26, the BITC defines ''profit'' as professional income earned by an enterprise/entrepreneur. Conversely, professional income earned by the manager(s) of a company is defined as ''compensation'' by virtue of BITC articles 30 and 32. Profit and compensation are mutually exclusive categories of earned income. The ruling does not address the question of whether an interest-free loan constitutes a non-arm's-length benefit for the taxpayer if the creditor is a private individual who does not carry on an enterprise.

A fourth observation regards the territorial aspect of articles 79 and 207 BITC. In their original form, articles 79 and 207 BITC were designed to prevent artificial profit shifting between Belgian domestic taxpayers. Indeed, why would one Belgian taxpayer artificially shift taxable income to another Belgian taxpayer, unless the beneficiary taxpayer receives some tax deductions to shelter the artificially shifted income? Conversely, when taxable income is (artificially) shifted from a non-Belgian person or entity toward a Belgian enterprise, the Belgian tax authorities have long considered that the other country should sanction the payer/grantor of the abnormal benefit while Belgium had no interest in sanctioning the recipient of the abnormal benefit. For many years, this view has been formally embedded in the Official Commentaries to the Income Tax Code (margin no. 79/12). Notwithstanding the announcement in 2002 that margin no. 79/12 would be deleted from the Official Commentaries, the ''safe harbor'' for non-Belgian-source abnormal benefits can still be found in the online version of the Official Commentaries. It would have been interesting for practitioners to learn the Antwerp court's view on the application of articles 79 and 207 BITC on abnormal benefits derived from a non-Belgian (Dutch) related party.

Lastly, the Belgian state may appeal the ruling by bringing the case before the Court of Cassation. In Belgium, the Court of Cassation cannot rule on facts or circumstances, but only on legal (or juridical) issues. In other words, the Court of Cassation cannot, for example, determine whether the benefits received by the taxpayer were abnormal, but it has the authority to rule whether the Antwerp Court of Appeal legitimately applied the relevant provisions of the directive to the case at hand. The Court of Cassation could, in all likelihood, also decide that the Court of Appeal should have submitted the case to the ECJ first, for a preliminary ruling on the correct interpretation of article 4(1) of the directive. ◆