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Belgium Renovates and Generalizes Coordination Center Regime

BY MARC QUAGHEBEUR (VANDENDIJK & PARTNERS, BRUSSELS)

In 1982 Belgium introduced a special tax regime for coordination centers that inspired similar measures in France, Germany, Luxembourg and the Netherlands. At the time the European Commission approved the coordination center tax regime. However, times change and in 2003 the European Commission decided that the coordination center tax regime was incompatible with EU state aid rules. Belgium agreed to modify the coordination center regime and phase it out by 2010.

Some 88 coordination centers are to loose their status by the end of this year and in order to give them plenty of time to adopt their structure to the new tax regime, the Belgian Parliament has adopted on 22 June 2005 (Belgian

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Proposed Introduction of REITs in Germany and the UK—A New Exit Opportunity for Real Estate Investors?

BY OLIVER FELSENSTEIN
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REITs (Real Estate Investment Trusts) are tax efficient mechanisms that permit investors to own, operate and invest in real estate assets. REITs have existed for a long time in the United States where they are now the main form of organization for publicly-traded real estate companies. REITs have existed in France since 2003 (known in France as SIICs—Societes d'Investissements Immobilier Cotees). Recently both the German and the UK governments announced plans for adoption of their own REITs; they are currently the only G7 economies without REIT legislation. If the U.S., Spanish and French experiences are followed, real estate portfolio companies may elect REIT status mechanisms to benefit from tax advantages and to give sponsors an attractive exit alternative compared to a traditional IPO.

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State Gazette 30 June 2005) a law that must make investments in equity significantly more attractive.

Coordination Centers

Belgian coordination centers have always been limited to large multinational groups with consolidated capital and reserves in excess of E 24,000,000 and a turnover of at least E240,000,000, and with a presence in at least four countries. Coordination centers can carry out certain financial and administrative coordination activities for the benefit of the companies of the group.

Coordination centers are typically used for activities of a preparatory and auxiliary nature (sales promotion and advertising, collecting and spreading information, scientific research, and relations with national and international government institutions), but mostly for insurance and re-insurance, the centralizing of financial operations (for example, re-invoicing, factoring, financial leasing and financing), the hedging of foreign exchange risks and the centralizing of accounting, administration and data processing.

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Although Belgian coordination centers are liable to corporate income tax at the normal tax rate of 33.99 percent, this tax is levied on a notional tax base determined as a percentage of certain operating costs. Initially personnel and financing costs were even excluded from this tax base. Furthermore, coordination centers are exempt from the capital duty of 0.5 percent of the share capital issued and the annual tax on real estate owned. More importantly, the coordination center was exempted from the obligation to withhold tax at source on the dividends, interest and royalties it paid out.

This made the coordination center a perfect vehicle for financing the companies of the group and to repatriate the profits to the parent company tax-free. Moreover, if the parent company financed the share capital of the coordination center with external funds, it could create a "double dip". While it can deduct the interest for income tax purposes the companies of the group that are financed by the coordination center can also take a deduction for the interest paid. For the coordination center the operation is neutral as it is taxed on a notional tax basis from which the financing cost was excluded. The only major cost was the withholding tax on the interest paid out by the group companies.

However, that is not an issue anymore since Belgium implemented EC Directive 2003/49/EC of 9 June 2003 which introduced a common system of taxation applicable to interest and royalties made between associated EU companies.

The coordination center was limited by a number of stringent conditions. The coordination center had to be approved by the Belgian authorities, it had to employ at least ten full-time employees in Belgium and the regime was limited to major multinational groups with a presence in at least four countries.

In spite of these requirements, Belgium soon acquired an international reputation as a tax-attractive location for finance centers. The introduction of similar tax regimes in France,

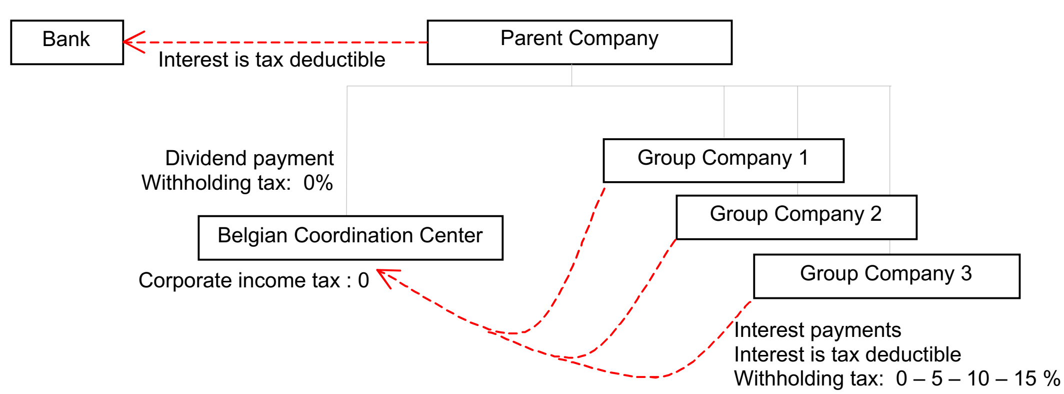

Table 1 : Benefits of a coordination center in a multinational group

Germany, Luxembourg and the Netherlands did not tarnish this reputation because Belgium offers a lot of other opportunities, a central location, a multilingual workforce, etc.

The EU Code of Conduct Group put the Belgian coordination centers on the list of potentially harmful tax measures and in 2003 the European Commission decided that this center tax regime was incompatible with the EU state aid rules.

The Belgian Government agreed to adapt the coordination center regime and to gradually phase it out by the end of 2010.

The Finance Minister declared that on 31 December the tax regime is to come to an end for some 88 coordination centers. This would entail the loss of 10,000 jobs and would lead to a direct tax cost of E700 million ($907 million) for the Belgian Treasury.

The New Tax Regime: The Risk Capital Deduction

The Belgian Parliament has now adopted a law that introduces a valid alternative. Contrary to the coordination center regime, the new regime is creative and simple.

As of next year, Belgian companies will be entitled to set off a new deduction against their profits. The idea behind the Risk Capital Deduction (which is also known as 'notional interest deduction') is that debt financing should not be privileged to the detriment of equity financing. Interest paid on borrowed funds is indeed tax deductible for the company, while dividends paid to shareholders are subject to corporate income tax. Moreover, Belgium does not have any thin capital rules to speak of. The Risk Capital Deduction is a compensation for the economic cost that using its own equity means for a company; it is a form of long-term, risk-free financing.

The deduction is a percentage of the company's equity to be calculated in function of the interest rate paid on 10-year linear bonds issued by the Belgian State during the past year. In June the rate was at an all time low of 3.21 percent. For the first tax year the percentage of the Risk Capital Deduction will be the average over 2005, 2006 will be the basis for the following tax year, and so on. However, the rate cannot vary more than 1 percent point from one year to the other. There is an overall ceiling of 6.5 percent but that is not engraved in stone: in years of high inflation the Government can raise the interest rate.

Annual averages of the interest rate on 10-year linear bonds issued by the Belgian State

2004	4.09%
2003	4.06%
2002	4.92%
2001	5.07%
2000	5.55%
1999	4.68%
1998	4.71%
1997	5.70%
1996	6.46%
1995	7.46%
1994	7.72%
1993	7.20%
1992	8.64%
1991	9.27%

For small and middle-sized companies the Risk Capital Deduction will be half a percentage point higher, if they waive the investment reserve to which they are entitled.

The Risk Capital Deduction will be calculated in function of the company's share capital and retained earnings. To avoid double tax exemptions and abuses a number of elements are to be excluded from this equity. This is the case for participations which the company holds in its own share capital, or participations and shares recorded as financial fixed assets as well as for participations in equity UCITS for which the company is entitled to the participation exemption that limits the double taxation on dividends received.

Belgium does not have any thin capital rules to speak of.

Most importantly, the net book value of an overseas permanent establishment (assets less liabilities attributable to the PE) and the net book value of overseas real property or real property rights are to be excluded from the company's equity.

Capital subsidies are to be excluded as well, as are capital gains that are merely recorded in the company's accounts in respect of assets that are excluded from its equity for the calculation

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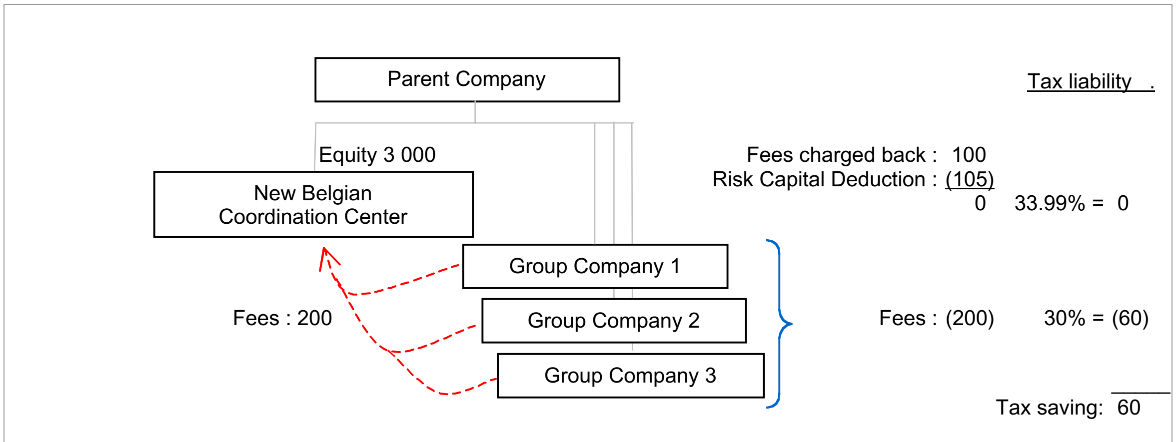

Table 2 : Belgian Coordination Center 'new look' with a Risk Capital Deduction of 3.5 percent

For small and middle-sized companies the Risk Capital Deduction will be half a percentage point higher, if they waive the investment reserve to which they are entitled.

of the Risk Capital Deduction. Further corrections are imposed to prevent the artificial inflation of the company's equity through the acquisition of tangible fixed assets at a cost that unreasonably exceeds the company's needs, of investments that are not intended to produce a regular taxable income (e.g. art, precious metals, etc) as well as of real property used by the director or his family.

The value of the equity must be determined on the basis of the company's latest annual accounts established in accordance with the Belgian GAAR. However, changes during the accounting year are to be taken into account on a month-by-month basis. The purpose of this provision is to prevent the manipulation of the share capital to increase during the tax year. The Minister of Finance confirmed that he did not expect companies to record the variations in their reserves (retained earnings and profit/loss accounts) on a month-by-month basis; what he wants to monitor are the changes in assets and shareholdings.

A Belgian company does not need a prior approval or advance ruling to be entitled to this exemption. The exemption will be calculated in the company's tax return. There is one condition though: the company must record an amount equal to the capital risk deduction on a separate account on the liabilities side of its balance sheet and maintain it there for three years. This means that the company cannot distribute this tax-exempt profit by way of dividend for at least four years.

Non-Belgian companies are entitled to the same deduction but only for the risk capital used for their Belgian permanent establishments or for their Belgian real estate or real estate entitlements.

The Risk Capital Deduction cannot be combined with other favorable tax regimes

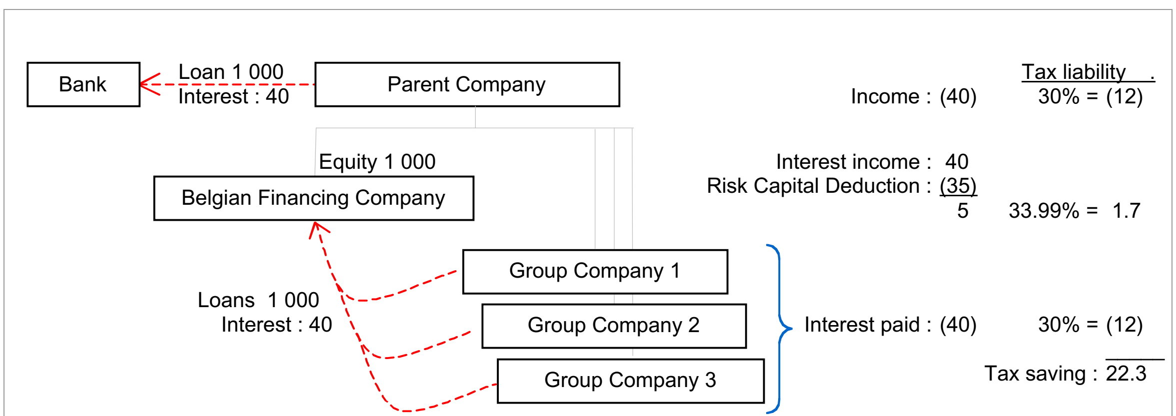

Table 3 : Belgian Financing Company with an optimised Risk Capital Deduction of 3.5 percent

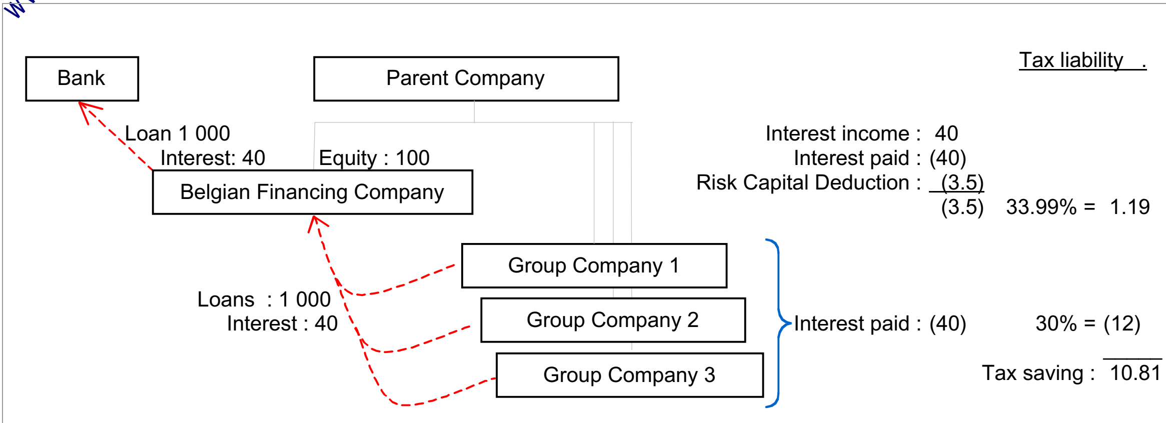

Table 4 : Belgian Financing Company with a Risk Capital Deduction of 3.5 percent

such as coordination centers or companies in reconversion zones, open-ended and closed-ended UCITS or undertakings for collective investment in receivables, cooperative participation companies set up to allow employees to participate in the profits of their employer, and shipping companies that pay the tonnage tax. Conversely, this means that other favorable tax regimes such as the cost plus tax regime for branches of foreign companies or the tax shelter for the audiovisual industry do not exclude the Risk Capital Deduction.

If the company cannot use part of the capital risk deduction, it can carry forward the deduction for seven years and set it off against profits of future years. In this respect, it is useful to point out that the capital risk deduction is taken before the carry forward of tax losses from previous years.

At the same time, it is worthwhile mentioning that the right to carry forward the Risk Capital Deduction can be lost in the same way as the right to carry forward tax losses in the case of a change of control over the company that is purely tax-driven.

A Winning Combination

This new tax regime offers a large number of opportunities, in particular when used in a combination with some other elements of the Belgian tax legislation.

1.No capital duty anymore

As of 1 January 2006, another hurdle to the capitalization of Belgian companies is to be brought down. Belgium is one of the countries that levies a capital duty on the share capital issued when a company is incorporated or when its share capital is increased.

In other European countries (Austria, Ireland, Luxembourg, the Netherlands, Spain and Switzerland) the duty ranges between 0.5 and 1 percent. Belgium may have been at the lower end in the list of countries levying such a duty, and even if this duty was tax deductible, it was still perceived as an unnecessary cost for the company. The 0.5 percent capital duty will be replaced by a fixed duty of E25 (about $30).

2. No withholding tax on inbound interest and royalties

By Royal Decree of 22 December 2003, Belgium has implemented the EC Directive 2003/49/EC of 9 June 2003 introducing a common system of taxation applicable to interest and royalties made between associated EU companies. No tax is withheld at source on the payment of interest between EU companies of the same group, if one EU company holds a 25 percent participation, or where a third EU company holds a 25 percent participation in both EU companies. The participation must be maintained for at least a year.

3. Minimizing corporate income tax liability

Where the other companies of the group can pay out interest or royalties without having to withhold tax, the Risk Capital Deduction makes a Belgian company an even more attractive vehicle for financing and licensing companies. The deduction can neutralize the taxation of these interest or royalties, so that the Belgian company can pay out the dividends tax-free in the form of dividends.

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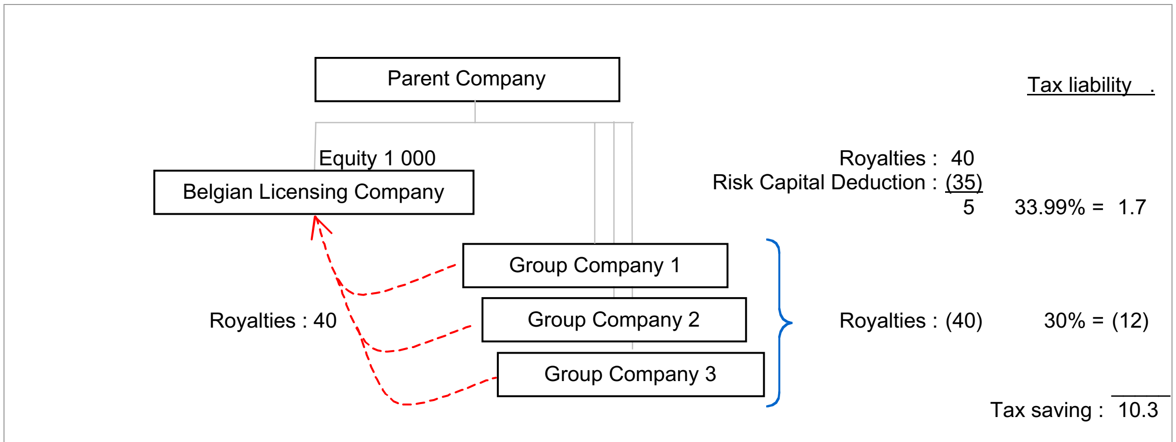

Table 5 : Belgian Licensing Company with a Risk Capital Deduction of 3.5 percent

However, this is not the only way of limiting the corporate income tax liability. The Risk Capital Deduction can be combined other tax exemptions such as

- The tax exemption of EUR 12,440 for additional staff assigned full-time in Belgium to scientific research, the development of the technological potential of the company, or for the jobs of head of the export department or head of the "total quality management" department. This exemption is EUR 24,870 if the person recruited is a highly qualified researcher assigned to scientific research.
- The tax shelter for for audio-visual works. Corporate income taxpayers are entitled to a tax exemption of 150 per cent of the funds they invest in the production of Belgian audiovisual work; the investment is limited to one third of their taxable profits before tax. This tax exemption can be carried forward indefinitely. Moreover, it does not seem incompatible with a cost plus tax agreement for branches of foreign companies or with other existing cost plus regimes for distribution and service centers.

As of next year, Belgian companies will be entitled to set off a new deduction against their profits. The idea behind the Risk Capital Deduction is that debt financing should not be privileged to the detriment of equity financing.

4. The Belgian holding company regime

Belgium does not have any particular holding company regime but the general corporate income tax system provides for a partial exemption of dividends received from qualifying participations. Although it would not be advisable to combine the benefits of a coordination center and a holding company in the same legal entity, a combination of both can be worthwhile.

Dividends are eligible for a 95 percent exemption if the parent company holds a participation that is at least 5 percent of the subsidiary's nominal share capital or, alternatively, that has an acquisition value of at least EUR 1,200,000.

Moreover, the subsidiary must meet a "subject-to-tax" condition, *i.e.* it must not fall within any of the specific anti avoidance exclusions.

Important is that capital gains on disposals of shares held in companies from which the dividends would benefit from the partial exemption at the time of the disposal are fully tax exempt.

Finally, Belgium does not have any controlled-foreign company rules.

5. Advance rulings

Like many other national tax administrations, the Belgian tax authorities want to provide greater certainty in tax matters to taxpayers, in particular to keep Belgium attractive for foreign investors. For that reason, Belgium has adapted its ruling practice to make it efficient, proactive and flexible and to provide the necessary certainty to Belgian taxpayers (see M. Quaghebeur, The Gateway between Europe and the Far East, *Practical European Tax Strategies*, May 2005, Vol. 7, Number 5, p. 18).

Since 1 January 2005, the Office for Advance Decisions in tax matters has been reorganized to give it more autonomy, and to make it pro-active and business-minded. The ruling committee should be able to provide rulings within a period of three months upon application for an advance ruling. The initial experience is certainly positive.

6. No withholding tax on dividends paid out to a parent subsidiary

In accordance with the EC Parent-Subsidiary Directive, Belgium does not levy withholding tax on the dividends it pays out to a parent company that holds at least 20 percent in its share capital (or voting rights) for an uninterrupted period of at least 12 months (10 percent in 2009).

Non-EU parent company will have to find a channel via Belgium's extensive treaty network to reduce the tax rate to 15, 10, 5 or even nil percent.

Examples

The Risk Capital Deduction can be the basis for a new type of coordination center regime. Given sufficient equity, any Belgian company (or even any Belgian permanent establishment) can start working as a coordination center for a group of companies.

They can take on activities such as sales promotion and advertising, collecting and distributing information, scientific research, and relations with national and international government institutions) and other activities of a preparatory and auxiliary nature.

The cost of these activities can be charged back to the group companies that use these services. Other options are insurance and re-insurance, centralization of financial operations, hedging of foreign exchange risks and centralization of accounting, administration and data processing.

However, just like the coordination center, the Belgian company can be a vehicle to finance the group companies and to repatriate the profits tax-free. Moreover, if the parent company can finance the share capital of the Belgian financing company with borrowed funds, it can maximize its profit (table 3). Both the parent company and the group companies can set off the interest paid against their profits. Given sufficient funding, the Belgian Financing Company can neutralize the interest income with the Risk Capital Deduction.

Other favorable tax regimes such as the cost plus tax regime for branches of foreign companies or the tax shelter for the audiovisual industry do not exclude the Risk Capital Deduction.

The advantage of such transaction becomes clear in a comparison with a situation where the Belgian Financing Company organizes its own financing (Table 4).

An alternative use for the Belgian company is as a licensing company. The figures would be the same as in table 2.

Conclusion

Belgium has acquired an international reputation as a tax-attractive location for finance centers, and this reputation has not been tarnished by similar tax regimes in France, Germany, Luxembourg and the Netherlands. The Risk Capital Deduction, combined with the abolition of the capital duty on the share capital issued, will put Belgian on the map again as a location for coordination centers and holding companies.

Belgium has many opportunities that add to its central location in Europe and a multi-lingual work force: the special tax status for expatriate non-Belgian employees, the favorable tax regime for Belgian holding companies without controlled foreign corporation rules, and a modernized advance ruling practice.

The combination of these elements means that Belgium cannot be disregarded for any international tax planning. ❑

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