Foreign Tax Credit : setback for Belgian Tax Authorities

In the mid nineties, the Anti-Fraud department of the Belgian Ministry of Finance announced they had uncovered a major scandal where nearly all Belgian banks had been selling Italian, Korean and Uruguayan bearer bonds and cash certificates to their clients to make a maximal use of the so-called 'foreign tax credit' in order to wipe out their liability to corporate income tax.

In one week's time, two courts have rejected some of the major arguments of the Belgian Tax Authorities.

Foreign tax credit

When a Belgian company receives interest from a foreign source, the payer usually has to withhold tax at source, at rates varying between 0.5 and 30 per cent. When the company declares the interest received, it cannot set off this tax withheld for the foreign tax authorities against its Belgian income tax bill.

Belgium does, however, grant some unilateral relief against this form of double taxation. This is the so-called 'foreign tax credit'[1] 'quotient forfaitaire d'impôt étranger' / 'forfaitair gedeelte buitenlandse belasting') to which a company is entitled if it can prove that tax has been withheld at source in respect of foreign-source investment income (other than dividends). This 'foreign tax credit' was granted on the assumption that the tax collected at source was 15 percent, irrelevant of the level of tax withheld abroad.

Until 1990, the credit was calculated at 15 / 85ths of the net interest collected. The foreign tax credit was added to the interest and the grossed-up interest included in the company's taxable income. The 'foreign tax credit' could then be set off against the corporate income tax due by the beneficiary but it is not refunded.

The law did not make a distinction as to the percentage or the amount of tax effectively withheld at source, and this could be very beneficial for the company. Even if the tax withheld at source was minimal, the company was still able to set off the full foreign tax credit of 15 / 85 against its corporate income tax liability.

The facts submitted to the Brussels court are a good example. In 1989, the company purchased Italian treasury bonds issued about a week before their maturity dates. It paid about € 10,750,000 for treasury bonds with a nominal value of € 10,000,000 to take account of the that would mature soon afterwards. The company collected about € 1,100,000 in interest after deduction of a small amount of Italian withholding tax (6.25 % at the time). A couple of days after the transaction, it sold the bonds for about € 9,700,000. The result for the company was negligible ; it made a minimal profit between the interest paid and the interest collected.

The company claimed a deduction for expenses of about € 150,000 in respect of bank charges and a foreign tax credit of about € 275,000 to be set off against its corporate tax liability. This tax credit was calculated for the full 15 / 85 of the net interest collected while the tax withheld in Italy was only 6.25 percent.

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[1] Article 187 paragraph 1 Income Tax Code 1964, which corresponds to Article 285 paragraph 1 Income Tx Code 1992.

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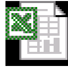
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Initially, the foreign tax credit was only used by the banks for their investments abroad, but at the end fo the eighties they turned it into a product which they sold to their clients. They searched for bonds which attracted a minimal amount of tax and a maximal foreign tax credit. Most popular were the bonds or cash certificates of Italian, Korean or Uruguayan origin. By combining a high interest rate, the foreign tax credit, the capital losses and the losses on the sale of the bonds and certificates, some banks were able to cancel out the corporate income tax due by their clients on their business profits. The banks charged a percentage of the tax saving realised by the company, and that fee was tax deductible.

In 1990 the law was adapted to limit the foreign tax credit in function of the period of time during which the company has held the foreign investments, and in 1993 a further limitation was introduced to limit the tax credit in function of the company's financing with loans.

The Italian bonds and cash certificates were particularly attractive because at that time the double taxation convention between Belgium and Italy provided for a form of tax credit as well. Article 23 paragraph 2 stated:

> "Subject to paragraphs 4 and 5 hereinafter, when a resident of a Contracting State receives income which according to the provisions of article 11 paragraphs 2 and 6 has effectively been assessed in the other Contracting State, the first State shall grant on the tax due on this income by said resident a deduction equal to 15 percent of the amount of the above mentioned income which is included in the basis that is taxable in the hands of this resident."

In the middle of the nineties, the Anti-Fraud department of the Belgian Ministry of Finance discovered that nearly all Belgian banks had been using this technique on an almost industrial scale, both for themselves and for their clients. The Department suspected that the number of bonds and cash certificates purchased largely exceeded those available and that in many cases, the transactions were fictitious.

However, they realised that they did not any legal basis against the banks. They found a stick to hit them in the Tax on stock exchange transactions[2]. This tax is due on the purchase or the sale in Belgium through a professional intermediary of existing certificates of bonds or treasury certificates, it is calculated at a rate of 0.07%. The Tax Authorities stated that the banks had been selling the bonds and certificates via their foreign subsidiaries in order to circumvent their obligations in respect of Tax on stock exchange transactions. In two operations ironically dubbed 'O Sole Mio' and 'Chicago', the police raided the offices and private residences of bank managers. Many banks have settled this tax and negotiated the amounts to be paid in fines. Criminal prosecutions have been launched against 17 banks and against about 25 bank managers who were named in person, but these court cases have not started yet.

The then Minister of Finance expressed his amazement that this trade in fiscal products had been possible in a legitimate manner and for such large amounts. The Department examined over 1,000 constructions, naming some of Belgium's major companies. It is estimated that these

[2] 'Taxe sur les operations de bourse' / taks op de beursverrichtingen'

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constructions have cost the Belgian treasury about 375 million EUR in corporate income tax.

A large number of companies settled. Most of them appealed with the Director of Taxes, who has often delayed his decision, presumably because the Tax Authorities were preparing their arguments before the courts and were waiting for a few favourable decisions. Two recent court decisions may prove that the companies that decided to fight back have been right all along.

Court decisions

The first court to hand down a decision on the 'foreign tax credit' was the Court of First Instance of Mons on 20 June 2003. Hardly a week later, on 26 June 2003, the Court of First Instance of Brussels followed suit with more or less the same arguments.

Both courts put the debate in a more serene light. The Brussels court explicitly states that it does not want to enter the quasi political debate as to whether fiscal engineering is legitimate. Both courts have analysed the arguments of both parties in great detail and found they could not accept any of them.

In the first place the Tax Authorities had argued that the sole purpose of the transactions was to wipe out the company's taxable profit. Consequently, the company did not meet the basic condition for an expense to be allowed, i.e. that the expenses must have been incurred in order to acquire or maintain taxable income[3]. This condition is based on the income tax rules for individuals but is generally deemed to be the complied with by a commercial company as long as the expenses relate to activities within the company's corporate object[4]. The Tax Authorities stated that the transaction did not fall within the company's activities so that the company could not claim a tax credit based on income from such activity.

This was not a problem for the Brussels court, even if the transaction was not meant to generate a profit. It suffices that the company intended to collect a taxable income (the interest), and this was the case.

The Mons court, on the contrary, highlights that this condition only relates to the deduction of expenses, and not to the offset of a tax credit against the company's tax liability. This is correct, but there is a specific provision that links the foreign tax credit to the company's business activities. The court however, sidestepped this issue and emphasizes that in any event the double tax treaty takes precedence so that any other conditions imposed under national law cannot restrict a unconditional tax credit which Belgium had agreed to in a convention.

The conclusion of the Mons Court of First Instance is, therefore, that the company had completely legally benefited from a favourable provision of international law that allowed the company to set off a tax credit under conditions which were not particularly restrictive. The provisions of the double taxation treaty cannot be set aside by domestic provisions that are different or more restrictive.

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[3] Article 44 ITC 1964 - Article 49 ITC 1992.

[4] Cass. 18 January 2001, Fiscale Koerier, 2001, 237 ; Cass. 3 May 2001, Tijdschrift voor Fiscaal Recht, 2001, 893

Before the Brussels Court of First Instance, the Tax Authorities had tried to find an argument in this convention to make the Belgian legislation more restrictive. Where the Belgian income tax law states that the 'foreign tax credit' is granted if tax has been withheld abroad, they stated, this had to be explained in accordance with the Belgian Italian double tax convention. The court merely confirms that an international convention cannot limit advantages granted to a taxpayer, but that it is only intended to limit the taxation powers of the State signing the convention.

The major argument put forward by the Tax Authorities was that the entire transaction was simulated. This meant that they were able to disregard the simulated transaction (purchasing bonds, collecting the interest and selling the bonds on) to look at, and tax the real transaction that is concealed. However, they were never able to pinpoint exactly what that concealed transaction would have been. After a detailed examination of the different elements which were put forward by the Tax Authorities, the Brussels Court of First Instance comes to the conclusion that the transaction was not simulated. The Mons court stated that the company had invested a capital and received an income, and that such income can only be qualified as interest. This interest gives the company an entitlement to the tax credit.

The claim that the company had purchased a consumer good and had paid the bank a commission fee for setting it up was rejected in particular by the Brussels court. Even if this analysis reflects the economic reality, it does not correspond to the legal analysis of the transactions, which contradicts this economic reality. The fact that the transactions have been recommended by, or even been set up with the help of, a bank in order to obtain a fiscal advantage, does not allow the Tax Authorities to reject the qualification given.

Where the Tax Authorities argued that the ownership of the certificates had never been transferred, the Mons court found that the accounting rules used by the company and the alternative accounting rules which the Tax Authorities insist that the company should have used, both assume that the company was indeed the owner of the certificates.

The Tax Authorities tried to demonstrate that each transaction constituted a single sale and repurchase agreement (REPO) : both transactions had been agreed simultaneously and were indissolubly linked between the same parties. The Brussels court rejects the allegation that this would mean that the company had not become the owner of the shares at the time the interest is paid out.

Another line of attack was that the purchase and sales operations were fictitious because the bank had infringed its obligations in respect of the Tax on stock exchange transactions.

Before the Brussels Court of First Instance, the Tax Authorities had attempted to prove that the company had infringed the stock exchange tax, but had not produced any evidence other than that the bank had signed a settlement agreement and paid the tax. It failed to give an explanation as to why or on what basis the bank had settled.

The Mons court, however, pointed out that the Tax Authorities cannot at the same time claim

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the tax on the stock exchange operations and take the position that the certificates had not changed owners. Both courts point out that in respect of the tax on stock exchange transactions it is the bank that is the tax payer, and not the investor.

Conclusion

The opening remark of the Brussels court and the conclusion of the Mons Court of First Instance seem appropriate for both situations. The discussion is clearly a political debate as to whether fiscal engineering is legitimate. And if there were favourable provisions of domestic and international law that allowed the company to set off a tax credit under conditions that were not particularly restrictive, the company has completely legally benefited from these provisions.

That these two decisions confirm that the transactions were legitimate after all is a major setback for the Belgian Tax Authorities in their fight against these 'foreign tax credit transactions', and it will encourage those companies that have decided not to settle but to fight back. Transactions with Korean or Uruguayan certificates risk being viewed less favourably, but the large majority of cases are similar to these submitted to the courts in Brussels and Mons.

One cannot ignore that both courts have taken their time to answer in detail all the arguments presented by the Tax Authorities. That both decisions have been rendered at the same time is probably nothing but a coincidence, but it is remarkable how both decisions complement each other. It will make it all the harder to find arguments to appeal them.

Nevertheless, that is exactly what the Tax Authorities have announced. They had put a large number of cases on the backburner in order to concentrate on a few test cases. However, in their reaction they appear to focus on one consideration in the decision of the Mons Court of First Instance, i.e. that no criminal prosecution had been filed against the company or its directors for using forged or counterfeited documents. This is why companies that have appealed the tax claims for the use of the foreign tax credit risk being indicted in the near future. Whether this will add anything to the debate is doubtful ; it only risks clogging up the judiciary system.

This is not the only issue on which the Tax Authorities have alerted the press and the politicians, creating a general impression of a major case of tax fraud, to see its arguments before the courts thrown out. The story of how a major scandal was uncovered has regularly made the headlines over the last eight years, and police raids emphasized how these cases would lead to major criminal prosecutions.

However, it is probably the largest case in scale and it may well become a case study as to how the taxman makes a case against a group of tax payers, persuades a number of them to settle before seeing the case rejected by the courts.

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20 August 2003