Reprinted from *Tax Notes Int'l*, November 8, 2004, p. 509

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Prosecutor Takes Aim at Tax Avoidance Schemes

by Marc Quaghebeur

The Antwerp public prosecutor's office on October 19 announced that it has started an investigation into a "cash company" tax avoidance scheme allegedly set up by the owner of Belgian electrical retailer Hugo Van Praag to avoid the payment of €10.41 million in corporate income taxes.

A cash company construction involves a cash-rich company that has successfully sold its assets, but has acquired a considerable capital gains tax liability. Under Belgian law, CGT is part of the corporate income tax. (The tax rate recently was reduced from 40.17 percent to 33.99 percent.) If the company reinvests the proceeds from the sale of its assets in other, qualifying assets, rollover relief is available for capital gains on the fixed tangible (and some intangible) assets that the company held for at least five years before the disposal.[1]

Cash company constructions can be doubly attractive for companies with large taxable profits and few possibilities to set off deductions against their profits. By selling the business assets to a second company with (almost) the same name and the same management structure, they can create new tax deductions, because the second company can depreciate the purchase price of the business assets. And if the second company finances the purchase, it can also set off the interest against its taxable profits.

In the related tax avoidance scheme, the owner of a cash company is approached by someone who offers to purchase the shares of the company at a discount of around 15 percent. If the purchaser, who gains control of the cash company through the purchase of its shares, effectively reinvests the cash derived from the sale, the seller legally escapes CGT by way of the rollover relief mentioned above. However, purchasers, instead of reinvesting the cash, often use it to repay loans they have taken out for the purpose of purchasing the cash company's shares, and fail to pay the resulting CGT owed by the cash company.

In the late 1990s, the Belgian tax fraud unit identified about 13 cash company tax avoidance schemes that together would have evaded some €744 million in taxes. The transactions were set up by a Belgian prince, a Brussels lawyer, and a Paris grocer, who allegedly approached companies and proposed that the owners sell their business assets to a new company, which would finance the purchase with back-to-back loans, after which the trio would purchase the original (cash) company's shares at a discount (gaining control of the company in the process). In the Hugo Van Praag case, tax officials allege that company owner Dirk Van Praag sold the Hugo Van Praag stores to the Kingfisher Group for €30 million in November 1999, and subsequently participated in the cash company tax avoidance scheme.

The public prosecutor's office in Antwerp started investigations in 2001 and announced recently that it will press charges against 44 businesspeople, bankers, consultants, tax advisers, and attorneys for tax fraud, fraudulent bankruptcy, and money laundering in connection with the cash company schemes. Meanwhile, in October 2002, the Brussels public prosecu-

[1]Article 47 of the Income Tax Code.

tor uncovered another network involving some 40 cash companies.

The CGT liability remains with the cash company, but because all of its cash has been drained, there is nothing for the tax collector to recover. And by the time the tax avoidance scheme is discovered, the purchaser of the shares has usually disappeared. Tax authorities' only recourse is to try to recover the tax from the unsuspecting seller of the original company's assets.

Tax authorities often base their claim on article 90 (1) of the Income Tax Code, 1992, which states that nonbusiness profits and gains are subject to individual income tax at a rate of 33 percent, unless they are derived from transactions that are within the limits of the "normal management of a private estate" (consisting of securities, tangible assets, or real estate).

Traditionally, the notion of what is not "normal management" was defined by reference to "speculative management," which involves the regular transactions of buying and selling with borrowed funds. However, for a couple of years now, tax authorities have gone far beyond the reference to speculative management in interpreting the notion of abnormal management. They have tried to tax gains that clearly are not derived from speculative transactions (for example, one-time transactions in which a long-term company owner sells his shares, and even reorganizations of companies held by individuals to put them under a holding company).

There is, however, little case law to back up tax authorities' position; most courts reject their arguments. The Court of First Instance of Nivelles, in a July 24, 2002, decision,[2] made it clear that one must distinguish between transactions involving the company and the sale of shares by the seller-shareholder. Moreover, it appeared that the price was not suspect in that particular case, and the court said nothing prevents parties from taking account of all elements, including considerations of tax due or avoided. The court also said the seller has a legitimate right to sell at the best price, and the fact that the tax law allows him to obtain the best price should not result in a different consequence than under different economic circumstances.

The Brussels Court of First Instance, in an April 17, 2003, ruling,[3] stated that article 90 (1) must be interpreted in a restrictive manner, and that taxpayers should be able to sell the shares of their company in the best possible circumstances. However, shortly before the sale in that particular case, the company was involved in some transactions that converted it into a cash company that was more valuable to sell. The court held that those transactions fell outside the normal management of a private estate and were, therefore, speculative. However, it refused to condemn the taxpayers to a penalty of 50 percent of the tax due for having used fraudulent mechanisms.

Another line of attack tried by the tax collector is to hold a company's former directors personally liable for payment of the CGT due by the company. Tax authorities base that claim on the directors' liability toward third parties. However, that argument is invalid unless serious misconduct can be proved.

Whenever possible, tax authorities try to involve the public prosecutor's office. However, the difficulty is that the criminal activity in the cash company takes place while the purchaser, who usually is a straw man (a sort of decoy), is appointed a director. It is difficult, if not impossible, to prove that the shareholder who has sold his participation is an accomplice to the straw man. However, criminal prosecution can persuade some businesspeople to settle, particularly when the owner of a company sells its assets using a straw man to purchase the company's shares or, as mentioned before, allows the sale of the business assets to be financed with a back-to-back loan.

In the Hugo Van Praag case, the public prosecutor's office claims that the cash company construction was entirely fraudulent, and that Dirk Van Praag and his adviser, an Ernst & Young audit partner, set up the construction with a Swedish straw man who purchased the company's shares and promised to invest the company's cash assets in mobile telecommunications. That plan never materialized. It remains to be seen whether the public prosecutor's announcement is more than just a scare tactic, and whether he will be able to sufficiently prove his claim. ✦

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[2]Fiscale Jurisprudentie/Jurisprudence Fiscale 2003/132.

[3]Fiscale Koerier 2003, p. 501.