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Belgian Supreme Court Limits Use of Antiavoidance Rule

by Marc Quaghebeur

In 1993 Belgium introduced a general antiavoidance rule in its Income Tax Code (ITC 1992), Inheritance Tax Code (IHTC), and Registration Tax Code (Reg. TC). Although the government is asking the Parliament to introduce a similar rule in the VAT Code, the Supreme Court on November 4 overturned a decision by the Liège Court of Appeal, possibly leaving no future for the antiavoidance rule.

In the case at issue, tax authorities tried to recharacterize a redemption of shares as a distribution of dividends based on the general antiavoidance rule in the ITC. The Court held that tax authorities can reclassify a transaction only if the reclassified transaction has the same legal consequences as the transaction as it was originally presented to tax authorities by the parties involved.

That decision was in direct opposition to a September 10, 2004, decision by the Liège Court of Appeal, which held that the general antiavoidance rule did not imply that both transactions (the transaction presented to the tax authorities and the alternative transaction) had to have the same legal consequences.

The Supreme Court's decision seriously limits the application of the statutory antiavoidance rule, making it nearly impossible for tax authorities to invoke the rule to recharacterize a transaction, as two different agreements or transactions will always have different legal consequences.

Background

General Antiavoidance Rules

Belgian tax law has several specific antiavoidance rules, but it wasn't until 1993 that it adopted a statutory general antiavoidance rule. Before 1993, the tax authorities could disregard an agreement between parties based only on the "simulation" or "sham" doctrine. Simulation is a civil law concept that implies that the parties to a transaction show the outside world a set of documents to indicate a specific agreement or transaction (for example, a loan) while secretly agreeing to a different agreement or transaction (for example, a contribution to the company's share capital).

Tax authorities can look beyond a simulated transaction to charge tax on the basis of the actual intended transaction, but the burden of proof is heavy. Tax authorities must show evidence that the taxpayer (and the other party to the agreement or transaction) intended to conclude a different agreement than the one disclosed in the documents of the transaction. That is almost impossible unless there is written evidence to that effect. Moreover, the Belgian Supreme Court has repeatedly decided that parties are free to conclude any agreements however they want, if they accept all the consequences and do not infringe any legal provision — even if the form they choose is not the most common one and even if they do so only to reduce the tax burden on the transaction.[1]

That gave tax authorities two alternative grounds for disregarding a disclosed (public) agreement and taxing the effects of the concealed (private) agreement: if the behavior of the parties to the agreement is not consistent with the public transaction, or if the public agreement or transaction is in breach of a compulsory legal obligation. When the authorities find such grounds, they can tax the effects of the concealed agreement.

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[1]*Brepols*, June 6, 1961: "There is no prohibited simulation and hence, no tax evasion, if, in order to enjoy a more favourable tax regime, and without infringing any statutory obligation, parties conclude agreements of which they accept all the consequences, even if the form which they give to these agreements is not the most common."

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However, tax authorities instead argued that tax must be assessed on the reality and that the transaction presented must therefore correspond to the "economic reality."[2] The Supreme Court decision in *Brepols* (June 6, 1961), which limited only those fiscal constructions that are not based on reality, was confirmed by the Court in the early 1990s, even for cases in which the only purpose of the transaction is to reduce the tax burden.[3]

The Statutory Antiavoidance Rule

To limit the application of that case law, Belgium in 1993 introduced a general antiavoidance rule in the Income Tax Code (article 344, section 1), in the Inheritance Tax Code (article 106), and in the Registration Tax Code (article 18).

> ***The Supreme Court's decision seriously limits the application of the statutory antiavoidance rule.***

Under the statutory rule, a taxpayer cannot oppose tax authorities' reclassification of a transaction if the authorities can prove that the parties to the transaction gave it one particular legal classification instead of another for the sole purpose of avoiding income tax. If that proof is established, the tax authorities can disregard the legal classification given by the parties to the transaction and reclassify the transaction to assess tax on a less beneficial basis. However, the taxpayer may protect its classification of a transaction if it can prove that the classification meets lawful financial or economic requirements.

Tax authorities also can use the statutory general antiavoidance rule when they can show evidence that parties have split a single legal transaction into separate legal transactions solely for income tax reasons. Tax authorities then can disregard the separate steps and treat the transaction as a single operation (the step-by-step doctrine).

The question whether the antiavoidance rule in the ITC violates the constitutional principle that there should be no taxation without representation was referred to the *Cour d'Arbitrage*, Belgium's Constitutional Court (for prior coverage, see *Tax Notes Int'l*, Dec. 6, 2004, p. 824), which upheld the general antiavoidance rule while clarifying the conditions for its application:

- The legal construction chosen by the parties must be selected to avoid tax, even if that is not the sole intent. That intent must be evidenced by the tax authorities through all means allowed by law.
- The application of the general antiavoidance rule is limited to transactions involving economic activities that result in profits or benefits that, in principle, are taxable. Transactions related to a person's private estate that have no taxable elements are to be disregarded.
- And when the taxpayer gives evidence to the contrary, it must show evidence that the legal classification given to the transaction meets lawful financial or economic requirements. In other words, it must show why it opted for that legal qualification and not for the qualification preferred by tax authorities.

Examples

The tax authorities have tried to apply the antiavoidance rule in the ITC to do the following:

Recharacterize a Redemption of Shares as a Distribution of Dividends.

Before 2001, it was more tax-efficient to redeem shares than to pay out a dividend on which withholding tax was due. Because that is not the most common way of paying out reserves, tax authorities have invoked the statutory general antiavoidance rule, classifying the transaction as a payment of dividends and charging the company the tax it should have withheld at source.[4]

Since 2001, the redemption price paid by a company for its own shares has been viewed as a partial liquidation of the company, and the company has had to withhold a 10 percent tax at source on that portion of the distribution related to those shares.

Recharacterize the Sale of a Life Interest as a Rental Agreement.

The tax on rental income is higher if the tenant is a company than if it is a private individual who uses the property as his personal accommodation. Instead of paying tax on a notional basis, the owner of the property must declare the net rental income. If he is also the director of the company leasing the property, part of the rent must be declared as director's fees and is taxed as earnings. Selling a life interest to the company for several years is more tax-efficient because the price is not considered

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[2]Court of Appeal Antwerp, Mar. 2, 1978; Feb. 27, 1987, Maas International; Jan. 29, 1988, Van Rompaey.

[3]Mar. 22, 1990, Au Vieux St. Martin.

[4]This was rejected by the courts of first instance in Arlon (Aug. 28, 2001), Antwerp (Oct. 26, 2001, and June 13, 2003), Brugge (May 3, 2004, June 7, 2004, and June 28, 2004), Hasselt (Jan. 9, 2002), Mons (May 8, 2003), and the Court of Appeal in Ghent (May 31, 2005). However, it was upheld by the Court of Appeal in Liège (Sept. 10, 2004); see below.

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taxable income. Tax authorities have tried to requalify those sales as rental agreements even when the rent has been paid in full in advance.[5]

Recharacterize a Rental and Subrental Agreement as a Single Rental Agreement.

Another practical solution to avoid the higher tax on rent is to split the rental agreement in two. The property is first leased to an individual, who then leases it to the company. The landlord enjoys a favorable tax regime (140 percent of the cadastral revenue), while the intermediary pays tax at a rate of 33 percent on his profit.

Tax authorities have disregarded a rental agreement between the owner of a property and her husband, and a subsequent rental agreement between the husband and the company in which he is a director, holding that there is only one rental agreement between the owner and her husband's company.[6]

Disregard the Existence of a Company.

Tax authorities sought to disregard the existence of a company in a case in which Company A sold its participation in Company B to Mr. X, and Mr. X later sold the shares in Company B to Company C for a considerable capital gain, whereupon Company B distributed a large part of its retained earnings to Company C. Tax authorities argued that Mr. X had set up the construction to acquire the reserves of Company B without paying the withholding tax. It charged Company B with the withholding tax it would have been required to withhold if the dividend had been paid directly to Mr. X.[7]

> ***The Court held that under the general antiavoidance rule in the ITC, it is only tax authorities' relassification of a transaction that cannot be opposed.***

In another case, tax authorities tried to look through an American company that had purchased a yacht and to consider the taxpayer as the owner and captain of the yacht. Thus, tax authorities tried to prove that the purchase price constituted disguised income for the taxpayer.[8]

The Supreme Court

The Belgian Supreme Court had a first chance to look into the application of the general antiavoidance rule in the ITC on April 21, 2005. In the case, the taxpayer and his wife were leasing their property to the taxpayer's company (Company C). In a set of contracts all dated the same day, they terminated the original rental agreement and replaced it with a rental agreement between the taxpayer and his wife and a real property company (Company F), and with a second rental agreement between Company F and Company C for a rent that was only slightly higher.

In a September 5, 2003, decision, the Mons Court of Appeal allowed tax authorities to disregard the different agreements and to go back to the original rental agreement. The Supreme Court confirmed that decision.

The role of the Supreme Court is not to examine the facts of the case, but to check whether the court of appeal has correctly applied the law.[9] In its November 4, 2005, decision, the Supreme Court had a chance to take a much stronger stance.

The Court held that under the general antiavoidance rule in the ITC, it is only tax authorities' reclassification of a transaction that cannot be opposed, and that tax authorities can reclassify a transaction only if the reclassified transaction has the same legal consequences as the transaction as it was originally presented to tax authorities. That decision in effect overturned the September 10, 2004, decision by the Liège Court of Appeal.

Conclusion

It remains to be seen how tax authorities will be able to use the general antiavoidance rule when they want to replace separate agreements or transactions with a single agreement or transaction. The April 21, 2005, decision of the Supreme Court seems to indicate that that should be possible. However, the Mons Court of Appeal did not consider the effect of the recharacterization for Company F, the shell company that was placed between both parties to the existing agreement.

Surprisingly, the House of Representatives is about to introduce a general antiavoidance rule in

[5]The Antwerp Court of First Instance rejected the recharacterization on June 19, 2002, but accepted it in principle in a January 6, 2003, decision, giving taxpayers the opportunity to demonstrate that they had lawful economic or financial reasons. The Antwerp court took a similar position on June 15, 2005, as did the Brugge Court of First Instance on June 22, 2004. The application of the general antiavoidance rule in the ITC also was rejected by the Ghent Court of Appeal on September 13, 2005.

[6]The Brussels Court of First Instance (Mar. 7, 2002) and the Mons Court of Appeal accepted the application of the general antiavoidance rule (Sept. 5, 2003); see below.

[7]The Ghent Court of First Instance rejected this (Dec. 2, 2004).

[8]The Antwerp Court of First Instance rejected this application of the antiavoidance rule.

[9]Article 147 of the Belgium Constitution.

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the VAT Code with similar terms to the rules in the ITA. The Administrative Supreme Court has suggested that Belgium wait for the decision of the European Court of Justice in *Halifax*, wherein the Court will determine whether a general antiavoidance rule is compatible with the EU Sixth VAT Directive. ◆

♦ *Marc Quaghebeur is with Vandendijk & Partners in Brussels.*

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