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ECJ to Examine Belgian Participation Exemption

by Marc Quaghebeur

The Antwerp Court of Appeal has sought a preliminary ruling from the European Court of Justice on whether Belgium's tax regime for dividends received by a Belgian company is compatible with the EC parent-subsidiary directive.

The parent-subsidiary directive establishes a common system of taxation applicable for parent companies and subsidiaries of different EU member states to prevent double taxation on dividends received.

When a parent company that has a participation of 15 percent (10 percent as of January 2009) in a subsidiary in another member state receives distributed profits, the country of the parent company must refrain from taxing those profits, or if it taxes the profits, must grant the parent company a tax credit for the corporation tax paid by the subsidiary (and any lower-tier subsidiary) on those profits. However, member states may disallow a fixed amount of the management costs related to the participation, up to a maximum of 5 percent of the dividends.

Moreover, profits distributed by a subsidiary company to its parent company are exempt from withholding tax both in the member state of the subsidiary and in the member state of the parent company.

Participation Exemption

Belgium implements the directive by granting a partial exemption to the parent company. If the parent company holds a participation that is at least 10 percent of the subsidiary's nominal share capital or, alternatively, that has an acquisition value of at least €1.2 million, the dividends are eligible for a 95 percent exemption. The subsidiary must not fall within any of the specific antiavoidance exclusions, which in practice implies that the subsidiary must meet a "subject to tax" condition.

In practice, however, the parent company may be barred from the full benefit of the participation exemption because of the method used to compute its tax liability. The full amount of all dividends received (the amount of dividends received net of foreign withholding tax, but grossed up with any Belgian withholding taxes) is first included in the company's taxable profits. Those taxable profits are then adjusted in seven steps. In the first step, the taxable profits are increased by the amount of any increase in the company's retained earnings,[1] the dividends it has distributed, and the amount of any expenses that are not tax-deductible. In the second step, the taxable income is divided into Belgian-source and foreign-source income (that is, profits attributable to a permanent establishment in non-tax-treaty countries and in tax treaty countries). Profits generated in a foreign PE located in a tax treaty country are discarded in the third step.

The company can then successively deduct 95 percent of the qualifying dividends received, as well as the risk capital deduction, the losses the company has carried forward from previous tax years, and some investment allowances. (For prior coverage of the risk capital deduction, see *Tax Notes Int'l*, June 20, 2005, p. 1035.)

It is only in the fourth step that the company can deduct the 95 percent of qualifying dividends received, insofar as there are any remaining taxable profits (article 205(2), Income Tax Code 1992). This has several consequences.

First, it means that the parent company must set off its net operating losses against the dividends received from qualifying participations and that the

[1] Alternatively, any decrease in the company's retained earnings is deducted.

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deduction of the participation exemption is limited to the net taxable income left after that compensation.

An example may help to clarify the situation. If a holding company receives no income in year 1 other than €1 million in dividends that qualify for the participation exemption, and does not have any disallowed expenses, its taxable basis is €50,000.

Taxable profit (after the first three steps)	€1 million
Dividend deduction	-€950,000
Taxable basis	€50,000

If the holding company had incurred tax-deductible expenses of €50,000, those expenses would have been deducted before the dividend deduction.

Taxable profit (after the first three steps)	€950,000
Dividend deduction	-€950,000
Taxable basis	€0

The problem arises when the company has more tax-deductible expenses. For example, if the company had taken out a loan to finance the acquisition of the shareholding generating the dividend income, and paid €700,000 in interest, that is also deducted before the dividend deduction, but the dividend deduction is limited to the remaining amount of net profits.

Taxable profit (after the first three steps)	€300,000
Dividend deduction: 95 percent of €1 million, but limited to €300,000	-€300,000
Taxable basis	€0

The "excess" of €650,000 of dividend deduction cannot be used and cannot be carried forward. Belgian tax law also does not allow a carryback of tax losses. If the same company has another €500,000 in tax-deductible expenses, apart from the €700,000 in interest expenses, the company has a net operating loss of €1.2 million, which means that it loses the participation deduction completely.

Taxable profit (after the first three steps): €1 million-€1.2million	-€200,000
Dividend deduction: 95 percent of €1 million, but limited to 0	-0
Taxable basis	€0

A second effect is that the existence of qualifying dividends can reduce the NOLs that can be carried forward to later tax years.

As the previous example shows, if the company had not received the dividend, it would be able to carry forward €1.2 million in tax losses without any time limitation. If the company has any losses from its operating activities, those are wholly or partially wiped out by the dividends qualifying for the dividend deduction. That part of the operating losses is not eligible for carryover to later tax years, and the remaining part of the dividend deduction is permanently lost, because no carryforward or carryback is available.

Finally, if the dividend income had been received in a year during which the holding company had generated other taxable income, the dividend deduction could be used as follows. Assuming that in year 2, the company receives the same dividend of €1 million and also generates €2 million in net operating profits:

Taxable profit (after the first three steps)	€3 million
Dividend deduction	-€950,000
Taxable basis	€2.05 million
Losses carried forward from year 1	-€1.2 million
Taxable basis	€850,000

Compatibility Questioned

The compatibility of this regime with the EC parent-subsidiary directive has been questioned. Article 4(1) of the directive requires member states that apply the exemption system to "refrain from taxing (the) profits." By including the dividends first in the taxable basis and excluding them only at a

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later stage, the dividends are indirectly taxed, since they reduce the amount of the losses carried forward.

Belgian Minister of Finance Didier Reynders defends the Belgian system on the basis that the directive does not require that the member states leave the carryforward of losses intact or make the exemption of the dividends itself subject to a carryover.

So far, the courts of first instance in Brussels and Antwerp have held that the Belgian participation exemption is incompatible with the parent-subsidiary directive. The first decision was rendered on April 25, 2003, by the Brussels Court of First Instance, which held that by restricting the participation exemption to the net taxable profit, article 205(2) of the Income Tax Code adds additional requirements that are not included in the parent-subsidiary directive, resulting in partial double taxation of the dividends received. (For prior coverage of the Court of First Instance's ruling, see *Tax Notes* Int'l, July 7, 2003, p. 43, *2003 WTD 125-3*, or *Doc 2003-15572*.)

The Court referred to the ECJ judgment in joined cases C-283/94, C-291/94, and C-292/94, *Denkavit Internationaal BV and Others v. Bundesamt fur Finanzen*, in which the ECJ held that (when implementing a directive) member states cannot unilaterally introduce restrictive measures, and that when they have an option, it is to be interpreted strictly because it constitutes a derogation from the principle of exemption from withholding tax provided for in article 5(1) of the parent-subsidiary directive.

Also, the Court of First Instance observed that a company that realizes a loss and receives exempt dividends is taxed on the profits realized in later years, whereas a company that does not receive exempt dividends is not taxed on those profits because of the loss carryforward. That means that if a company receives dividends that qualify for the participation exemption, its right to carry forward losses is reduced. Accordingly, those dividends are not fully exempt, and that is incompatible with article 4(1) of the parent-subsidiary directive. As a result, the Court allowed the carryforward of the difference between the dividend deduction and the amount of losses carried forward.

In a December 16, 2005, decision, the Court of First Instance in Antwerp followed suit and decided that to be compatible with the directive, the participation exemption must allow a carryforward. It repeated that principle in a November 15, 2006, decision, but surprisingly extended the benefit of that rule to dividends received from Belgian subsidiaries, though the Belgian government had argued that a parent company can invoke the direct effect of the parent-subsidiary directive only for cross-border payments of dividends within the European Union.

The Court rejected that argument, referring to the ECJ judgment in *Leur-Bloem* (C-28/95). The Antwerp Court of First Instance decided that it has jurisdiction to interpret EU law when the situation in question is not governed directly by EU law but when the national legislature, in transposing the provisions of a directive into domestic law, has chosen to apply the same treatment to purely internal situations.

In this case, Belgium has adapted its domestic legislation to the parent-subsidiary directive and treats the domestic payment of dividends in the same way as the cross-border payment of dividends within the European Union. The parent company is entitled to the participation exemption for both.

The tax authorities have appealed the Court's December 16, 2005, decision, arguing that the participation exemption does not infringe on the parent-subsidiary directive; they even contest that the directive would have direct effect.

In an interim decision, the Antwerp Court of Appeal on February 27 decided to ask the ECJ to decide whether the manner in which Belgium applies the participation exemption is compatible with the provision of the directive that the member state in which the parent company resides must refrain from taxing the profits. ◆

♦ *Marc Quaghebeur, Vandendijk & Partners, Brussels*