

Tiberghien

NOTIONAL INTEREST DEDUCTION : THE BELGIAN EXPERIENCE¹

The law of June 22, 2005² introduced in Belgium the so-called 'Deduction for Risk Capital' which is meanwhile better known under the designation 'notional interest deduction' (hereinafter: NID). The law of June 22, 2005 inserted the new Articles 205bis to 205novies in the Belgian Income Tax Code (hereinafter: BITC).

The accompanying explanatory memorandum³ is remarkably short and refers to the following as main objectives of the NID regime:

- To eliminate the difference in the tax treatment of risk capital and borrowed funds. There exists/existed the urgent need to abolish the discriminatory tax treatment of risk capital and borrowed funds, since in the case of borrowed funds, an interest at arm's length is deductible as business expense⁴, while in case of own funds or risk capital there was no such deduction provided for. The Belgian government also made reference to the fact that companies established in Belgium should be able to cut down costs as much as possible to be competitive at the European level.
- To strengthen the equity capital structure of enterprises, particularly small and medium-sized enterprises (hereinafter: SMEs), and as such to improve their solvability and consequently protecting them against the risks of bankruptcy.
- To provide a credible and competitive alternative for the privileged tax regime granted to coordination centers, which Belgium had to phase out since it was held by the European Commission to amount to state aid that is incompatible with the common market. In the opinion of the Belgian Government, the NID regime was the only credible alternative to keep those centers in Belgium.

It has been generally assumed that it was mainly this last justification which spurred on the Belgian government to come up with a 'Europe-proof' alternative for the coordination centers. In the explanatory memorandum there can consequently only be found an indirect reference to the lowering of the corporate income tax rate, nonetheless that the NID was a reaction to the general tendency towards a further decrease of the corporate income tax rate in the EU Member States (the so-called 'race to the bottom').

Hereinafter will be analyzed the above listed objectives. Besides, it is remarkable that there are only a few recent studies available on this topic. Hence, we have to rely significantly on a report made by the National Bank of Belgium (hereinafter: NBB)⁵, which unfortunately dates back from July 2008, and furthermore on a number of academic analysis's.

¹ Bernard PEETERS & Thomas HERMIE, Tax lawyers at Tiberghien Lawyers, Brussels.

² The Law of 22 June 2005, introducing the deduction for risk capital, *State Gazette*, 30 June 2005, as implemented by the Royal Decree of 17 September 2005 (*State Gazette*, 30 September 2005).

³ Preparatory Works, Parl. Doc. Kamer 2004-2005, No. 51-1778/001.

⁴ Moreover, no 'real' thin capitalization rules are *de facto* implemented into Belgian law.

⁵ "Macro-economische en budgettaire impact van de aftrek voor risicokapitaal", NBB, 22 juli 2008.

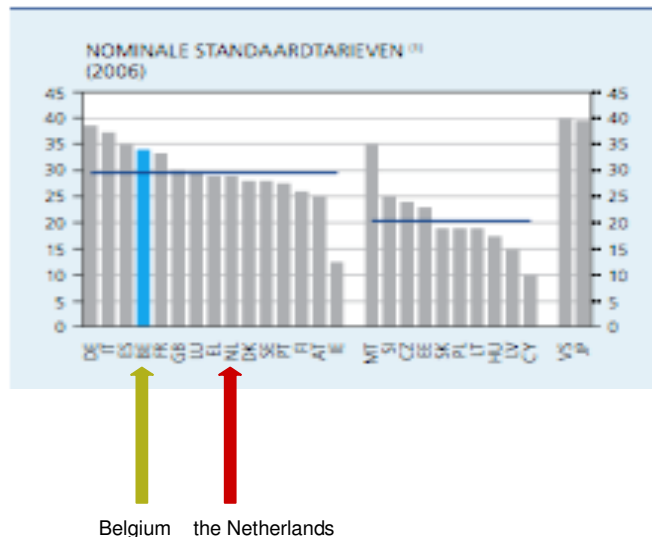
1. Objectives

1.1. Lowering the corporate income tax rate and strengthen the competitiveness of Belgium

In spite the fact that Belgium had lowered the corporate income tax rate in 2002 from 40,17 % to 33,99%, its nominal corporate income tax rate was at the moment of the introduction of the NID in 2005 one of the highest among the EU Member States. Yet, economists pointed out that foreign investors generally are too much blinded by the nominal corporate income tax rate when making investment decisions, while it is in fact the effective rate which is more important. But possibly Belgium scored in those days even worse on that point.

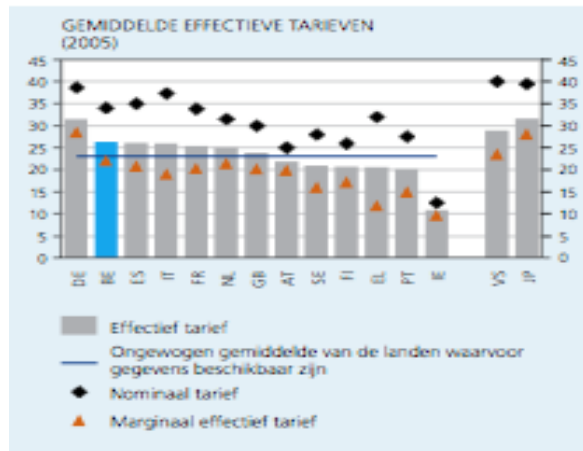
Moreover, by means of the NID, Belgium tried to keep up with the general tendency in Europe of decreasing the nominal as well as the effective income tax rates. This competitive struggle increased significantly from 1 May 2004 on, i.e. the moment when the ten new Member States acceded the EU. In 2006, the average nominal corporate income tax rate in the fifteen original Member States amounted up to 29,5%, while this rate in the ten new Member States only added up to 20,6%⁶. Belgium tried through this innovative and original measure to remain fiscally competitive. Notwithstanding this, the presumable complete truth is that besides the aim to distinct itself from the other EU Member States in the whole never ending 'race to the bottom' Belgium was also looking for an 'Europe-conform' solution for the coordination centers which remained in Belgium.

1. Nominal corporate tax rates (anno 2006) (source: *Economisch Tijdschrift 2007*)

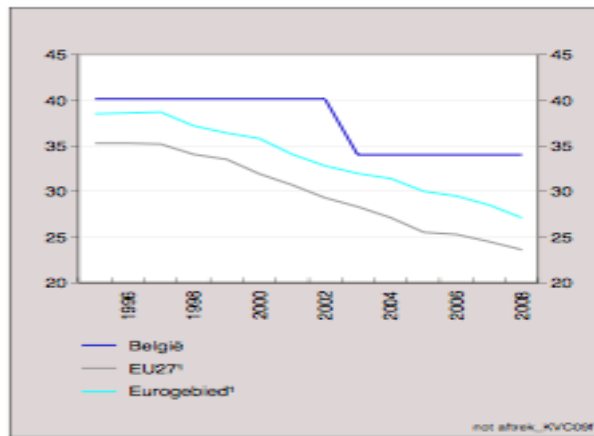


2. Average effective corporate tax rates (anno 2006) (source: *Economisch Tijdschrift June 2007*)

⁶ Van Cauter K. and Van Meensel L. 'Recente tendenzen inzake vennootschapsbelasting', *Economisch Tijdschrift I*, 2007, Nationale Bank van België, at p. 67; Vandenbusche H. and Crabbé K. 'Vennootschapsbelasting: de positie van België in het verruimde Europa', <https://lirias.kuleuven.be/bitstream/123456789/122710/1/0562.pdf>.



3. Evolution nominal corporate tax rates (source: Nationale Bank van België)



1.2. Enhance and increase the equity of Belgian companies

Belgium was not inexperienced in pursuing such objectives. Already in the 1980's Belgium had introduced the so-called Royal Decree nr. 15/150 which its main objective was to strengthen the own funds of Belgian enterprises through tax incentives in the field of individual income taxes as well as corporate income taxes.

This was at that time an absolutely necessary measure since Belgium was obliged by its instable solvency situation to issue massively government bonds. Because the state had to rely so heavily on the national savings, it skimmed the capital market at the expense of productive investments, i.e. the risk capital. The adverse effects on the Brussels Stock Exchange were substantial⁷.

The success of the R.D. No 15/150 was overwhelming. It is generally assumed that this measure, in combination with the devaluation of the Belgian Frank, helped Belgium through the difficult economic situation at the early 1980's.

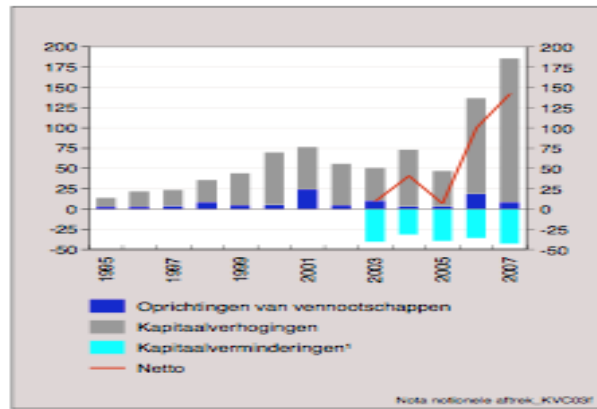
In 2005, through introduction of the NID, the Belgian government attempts to reduce the gap in the tax treatment of interest payments and dividends and to promote capital-intensive investments in Belgium.

The limited (amount of) studies which have analyzed the impact of the introduction of the NID on the amount of own funds of Belgian companies, all point out that it is mainly in this area that the NID booked its biggest success⁸. Indisputably the own funds of Belgian companies have increased and the borrowed funds decreased since the introduction of the NID. It can be assumed that the Belgian government has achieved this second objective with distinction.

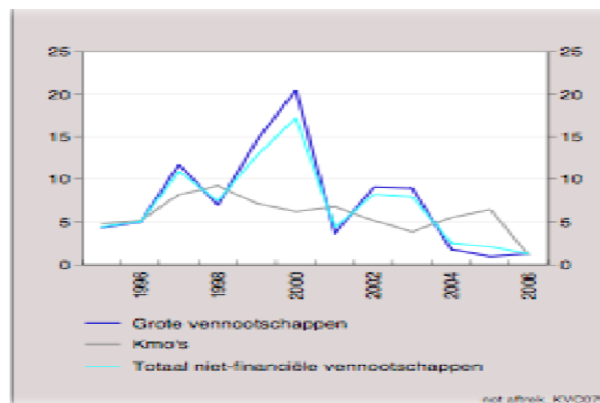
1. Evolution of equity of Belgian companies (*in billion euro's – source : NBB*)

⁷ Colmant B., 'Fiscale stimulatie van het risicokapitaal', *Accountancy & Tax* 3(2009), at p. 18;

⁸ Burggraeve K., Jeanfils Ph., Van Cauter K. and Van Meensel L., 'Macro-economische en budgettaire impact van de belastingaftrek voor risicokapitaal', <http://www.nbb.be/doc/ts/Enterprise/Press/2008/Gouvernement080623NL.pdf>;



2. Evolution of debt of non-financial Belgian companies (source : NBB)



1.3. Keep the residual coordination centers in Belgium

The coordination centre regime was enacted in 1982. In the early 1990's more than 250 multinational groups had established a coordination centre in Belgium. The impact of the regime on the Belgian economy has always been disputed. Critics pointed out that the coordination centers created all in all very expensive jobs⁹ while proponents indicated that the presence of those centers had a difficult to quantify, yet indisputable positive effect on the Belgian economy.

Anyway, the controversy caused by those coordination centers, together with the upcoming pressure from the European Commission, which successfully attacked the existing coordination centre regime under the state aid rules¹⁰, lead to the fact that at the moment of the introduction of the NID only 121 coordination centers remained in

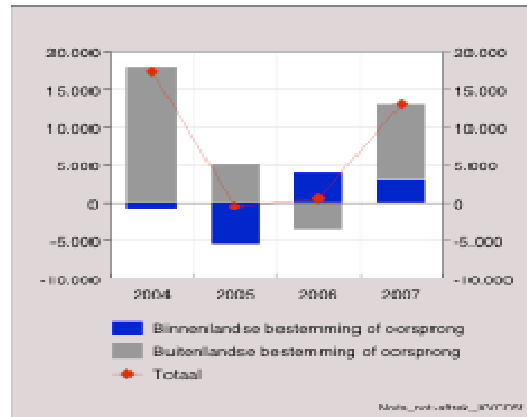
⁹ Coordination centers needed to hire a minimum of 10 employees in Belgium.

¹⁰ The Belgian Coordination Centre regime is fully terminated with effect from 1 January 2011, due to the expiry of the transitional regime on 31 December 2010. Qualifying coordination centers that were approved by royal decree were granted a favorable tax treatment for a (renewable) period of 10 years.

Belgium¹¹ of which more than 100 made use of the NID. Nonetheless, it appears now that more than 85% of those coordination centers would have remained in Belgium anyway. Besides, it seems that the anticipated capital outflow which was caused by systematic liquidations of the coordination centers has stopped now. Moreover, since the introduction of the NID, a net-capital increase has occurred.

Also in this sphere, it seems that the Belgian legislator has achieved its objective. It should be noted however that the international competition (especially with Switzerland) becomes stronger and stronger.

*Net change in the capital of the residual recognized coordination centers in 2004
(source :NBB)*



2. The Law

At the end of the article is enclosed an overview of the provisions of the Belgian Income Tax Code which deal with the NID.

Hereinafter is given an overview of the main principles of the NID:

- The notional interest deduction is a deduction of a fictitious interest equal to a certain percentage of the equity of any Belgian or foreign company subject to the standard corporate income tax regime in Belgium. This regime became applicable as from tax year 2007. A Belgian company (or permanent establishment) may deduct a notional interest based on its equity capital. The equity to be taken into account is the company's slightly corrected equity (share capital and its retained earnings) at the end of the previous book year, as it appears from the annual accounts.
- The deduction is calculated by multiplying the equity by a fixed percentage, determined by the government on the basis of the annual average of the monthly

¹¹ Source: Forum 187 (an organization which defended the interests of the coordination centers throughout several years).

published reference indices of the interest rate on 10-year linear government bonds (the so-called OLOs) in the second year proceeding the assessment year. For the assessment year 2011, the rate was capped at 3.8% (4.3% for SMEs). For the assessment year 2012, the rate applicable is 3,425 %. For SMEs the rate is increased to 3,925%.

- The deduction is correspondingly granted to non-resident companies that are subject to the income tax on non-residents in respect of their Belgian permanent establishment or immovable property (or rights thereon) located in Belgium. The NID is not eligible for one-person enterprises.
- The deduction is based on the company's aggregate net equity amount (i.e. its share capital, subject to certain adjustments, and retained earnings) at the end of the preceding financial year. To obtain the correct net equity amount, the risk capital must be reduced by the certain items of which the hereinafter listed items are the most important ones:
 - The deduction of the book value of shares qualifying as fixed financial assets (participations) and own shares. This aims to avoid a so-called "cascade effect". Without the deduction from the value of the company's equity of the fiscal net value at the end of the previous taxable year of shares in other companies, a share in the hands of one company represents part of the capital of another company, which itself qualifies for the deduction of risk capital, and consequently would result in ('a cascade' of) multiple NID. To avoid this "cascade effect" (i.e. with one capital injection a 'cascade' of Belgian subsidiaries all would be eligible to the NID), the financial fixed assets (should be excluded from the basis).
 - If a company has a permanent establishment or owns real estate in a country with which Belgium has concluded a double tax treaty, the computation base does not include the net book value of the assets and liabilities connected with that permanent establishment or real estate. The reason is that the permanent establishment's income or the income from the real estate is exempt from tax in Belgium under the applicable tax treaty and the Belgian legislator was of the opinion that only equity-generating taxable income in Belgium should be taken into account for calculating the benefits from the NID. Hereinafter will be demonstrated that the European Commission disagrees on this topic.
 - Some variations in the equity in the course of the book year (such as dividend distributions, redemptions of capital, etc...) have to be taken into account (namely from the first day of the month following the transaction).
 - Also tax-free revaluation gains and capital subsidies have to be deducted from the calculation base. The opposite would result in an incentive for companies to revalue their assets as much as possible
 - Furthermore does the Art. 205ter et seq. BITC contains a limited number of anti-abuse provisions which however will not be covered here since it falls outside the scope of this contribution.
 - If the company's taxable basis is insufficient to absorb the full amount of the notional interest deduction to which it is entitled, the excess can be carried over up to 7 consecutive years. The entitlement to such a carry-forward will, however, be lost in the case of a change of control over the company when such a change cannot be justified by legitimate business reasons.

Albeit some economists defend a reduction of the nominal corporate income tax rate, since it is in an international and competitive context more effective, the Belgian government succeeded to keep the fundamental principles of the NID very basic and

simple. The biggest asset of the NID in the international context is probably that on the first bracket of the return on the own funds (3,425 % for the assessment year 2012) no tax at all is due. Depending on the industry and the expected 'return on investment' it is quite easy to determine the situations when emigrating to a state with a lower corporate income tax rate become more advantageous.

3. The European Dimension

When the NID was introduced, the Belgian legislator was convinced that the NID was completely 'Europe-proof' since in the explanatory memorandum is explicitly stated that the deduction is completely consistent with the Belgian constitution and EU law¹². Since the Belgian government was (and is still) convinced that the NID legislation is state aid proof, it didn't notify the European Commission as is provided for in Art. 107 TFEU (ex. Art. 87 TEC). Nevertheless, this position has been questioned from the beginning on¹³.

First of all, in the Belgian legal doctrine the question was raised if by excluding the financial fixed assets, the NID regime constitutes a measure prohibited by Art. 49 TFEU (freedom of establishment) and 63 TFEU (free movement of capital) since it is likely to discourage a member state's resident from making investment in other states¹⁴. If a Belgian resident company which has a subsidiary, it will be effectively denied the benefit of the NID in respect of its own funds attributable to the investment in the subsidiary. The subsidiary, however, will be able to claim the NID but only if that subsidiary is a Belgian resident company¹⁵. This doctrine claims the NID regime is discriminatory on a consolidated basis.

Reference has to be made to the action undertaken by the European Commission on February 19, 2009¹⁶. Indeed, the European Commission opened an infringement procedure against Belgium on the grounds that the notional interest deduction regime violates the freedom of establishment (Art. 49 TFEU) and the free movement of capital principles (Art. 63 TFEU).

The fact that, under the current regime, the net equity corresponding to the net value of a branch or real estate located in a double tax treaty state is excluded from the basis on which the notional interest deduction is computed has been challenged by the European Commission since this exclusion does not apply to similar investments made in Belgium. A Belgian corporation cannot benefit from the notional interest deduction on the part of its equity that is attributable to a PE whose profits are exempt by virtue of a tax treaty. On the other hand, the new Art. 236 BITC makes the NID available to non-resident companies in respect of the risk capital attributed to their Belgian establishments as well

¹² In the preparatory works to the Law of June 22, 2005 we read : "The NID is the only credible and competitive alternative which is available for maintaining decision and coordination centers in Belgium and all professional activity linked to it, and for which Belgium has gained in the past 20 years a know how which is unique in the world." Additionally is provided that "The proposed deduction will be applicable to all Belgian companies and foreign companies taxable in Belgium, except those benefiting from a special tax regime. The NID deduction is further fully compliant with European and Belgian constitutional provisions."

¹³ What the European Commission understands under "No selectivity or specificity" is set out in the Commission notice 98 C-384/03.

¹⁴ DASSESSE M., 'Does the Belgian DCR regime infringe European law?', *Tax planning international* 1(2009), 31-36.

¹⁵ DASSESSE M., 'Les intérêts notionnels à l'épreuve du droit communautaire. Le législateur belge a la mémoire bien courte' in *Liber Amicorum Jacques Autenne* (Brussels, Bruylant, 2010), p. 231-243. See also DASSESSE M., 'Does the Belgian DCR regime infringe European law?', *Tax planning international* 1(2009), 31-36, at p. 32.

¹⁶ VANHULLE H. and VAN ROBBROECK N., "Europa ondervraagt België over territoriale werking NIA", *Fisc. Act.* 1(2009), at p. 1.

as their real property situated in Belgium (and the real property rights attaching to the same) in accordance with the conditions and modalities determined.

The European Commission asked Belgium to submit its observations. It has to be noted that the Commission is not challenging the entire notional interest deduction regime since the Commission has not asserted that the regime is incompatible with EU state aid rules.

The competent Belgian Secretary of State Wathelet¹⁷ has already announced that it is not opportune to extend the NID regime. This regime is namely applicable in situations where assets allocated to permanent establishments and real estate in foreign states generate income which is not exempted in Belgium. The NID is also applicable in case of a Belgian subsidiary of a foreign company. The Secretary of State is of the opinion that the infringement finds its origins in the lack of harmonization within the EU in the field of (direct) taxation. He claims that a state is not obliged to adapt its tax system to the tax system of another state.

To replace the NID by another measure seems in his opinion inappropriate. He refers to the fact that the EU Commission doesn't see the NID as forbidden state aid but that this regime only constitutes an infringement of the freedom of establishment principles and the free movement of capital (Art. 49 and 63 TFEU).

Based on this response of the Belgian government, the European Commission will decide whether or not to initiate a formal infringement proceeding against Belgium, eventually leading to a referral to the European Court of Justice. It seems however very unlikely that the argumentation used by the Secretary of State has convinced the European Commission.

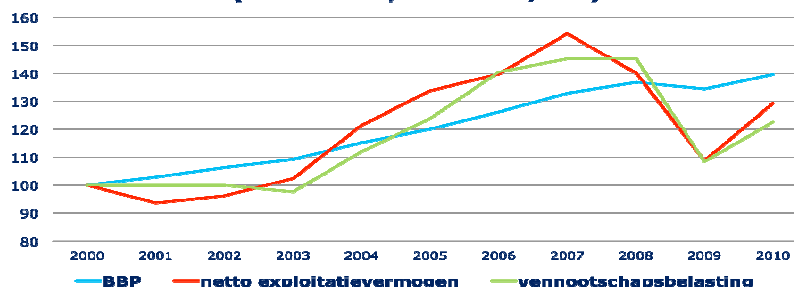
Nonetheless, since infringements of the EU freedoms have no retroactive effect and no challenge is being made under EU state aid rules, there is no risk that notional interest deductions claims that already have been made will be disallowed or may have to be refunded in the future. Indeed, the infringement procedure, if successful (and depending on how the Belgian government would amend the regime) might create opportunities for certain taxpayers in the future since it might lead to an increase of the notional interest deduction against Belgian taxable income by abolishing the above deductions from the notional interest deduction basis.

4. Economic impact

As is mentioned above has the Belgian government achieved two of the objectives it had in mind when introducing the NID: i.e. a positive influence on the own funds of Belgian companies and to keep the remaining coordination centers in Belgium. To evaluate the influence on the effective corporate income tax rate is more difficult to estimate.

¹⁷ Parliamentary questions 28 January 2010, A. Vandermeersch to the vice-prime minister and en minister of Finances concerning the "notional interest deduction", No. 4-1395.

**Budgetary evolution Belgian corporate taxes
(2000 = 100; source EC/FEB)**



	Advance payments	Assessment register	Total corporate taxes	Increase
2000	9.236.428	144.101	9.380.529	4,1%
2001	9.208.481	440.750	9.649.231	2,9%
2002	8.618.702	806.516	9.425.218	-2,3%
2003	8.546.256	754.583	9.300.839	-1,3%
2004	9.724.017	726.155	10.450.172	12,4%
2005	10.276.923	841.860	11.118.783	6,4%
2006	10.845.123	1.043.994	11.889.117	6,9%
2007	11.546.570	1.340.205	12.886.775	8,4%
2008	11.353.608	1.532.977	12.886.584	0,0%
2009	8.393.545	794.213	9.187.760	-28,7%
2010	9.318.625	1.209.304	10.527.929	14,6%

Whereas the Belgian nominal corporate income tax rate remains at 33,99%, after the introduction of the NID, it has been calculated that the NID reduces the effective tax rate to an average of 26%. The effect on the effective corporate income tax rate is nonetheless harder to estimate. The effective rate is considerably lower (sometimes as low as 0%) for capital-intensive activities such as financing. The practical implications of the NID are far-reaching and go from an implicit general reduction of the corporate tax rate to the need to rethink the techniques for financing a company and group structures, and the potential setting up by every group of an intra-group financing company¹⁸.

In the earlier mentioned survey made by the NBB¹⁹ it has been stated that the NID results in a lower effective rate of corporate income tax for companies established in Belgium. Through this measure, the effective tax rate (for the assessment year 2007) in case of a company who realizes a return of 15% on the own funds before taxes, and is not entitled to any tax deduction, is reduced to 26,2%. On the other hand, if the company only has a return of 5% on the own funds before taxes, the effective tax rate will be reduced to 10,6%. As already stated is this measure is very interesting for financing companies.

The effect of the NID on the job market is more complicated to determine. There are barely reliable figures available on this subject matter. In the above mentioned survey, the NBB stated that the NID leads to a marginal positive employment growth. However

¹⁸ *L'Echo*, 7 September 2005.

¹⁹ "Macro-economische en budgettaire impact van de aftrek voor risicokapitaal", NBB, 22 juli 2008.

the NBB proclaimed that it was too soon after the introduction of the NID regime to analyze the effect on the amount of jobs (in the different industries).

It is clear however that the regime has attracted a series of multinational companies.

5. Cost

The NID was introduced in part to attract new equity-funded entities and activities to Belgium and to provide a replacement for the successful coordination centre regime which is competitive with the systems introduced by other countries. The NID has therefore been heavily promoted by the Belgian government. On the other hand there is a public debate going on in Belgium on the NID. The topic of this discussion is that the budgetary impact of the NID would be higher than initially expected. As a consequence of this discussion has the Belgian government in 2008 decided not to change the NID, but to issue regulations²⁰ on the application of the existing anti-abuse measures that can be used to challenge abuses of the system. The government announced that it will continue to evaluate the NID, in particular regarding the budgetary impact and whether the current system has succeeded in reaching the objectives the legislature had in mind when it introduced the NID.

Notwithstanding this, it is very arduous to quantify the budgetary impact. The gross cost of the NID is relatively easy to calculate. It is however, the net cost that is highly debated (there are even large deviations among numbers given by official authorities such as tax authorities on one side, and the National Bank on the other side).

A first difficulty is to quantify the (remaining) effect of the (residual) coordination centers. A consequence of the introduction in 1982 of this regime is that the impact of the loss of corporate income tax revenues has been factored since a long time when making up the Belgian budget. As far as the NID constitutes a replacement of the coordination centers, it can't be labeled as an extra cost. This effect is estimated at EUR 2,4 mil. Besides, it is particularly this difficulty, i.e. of determining the budgetary effect of the introduction of a similar regime, which impedes other EU Member states of introducing such similar regime.

Another difficulty when measuring the impact on the budget is that, when introducing the NID regime, the Belgian government assumed that it would have a neutral impact on the Belgian budget despite the extra cost of ca. EUR 500 mil. To realize this fiscal neutrality, some other compensatory measures were taken.

²⁰ Tax regulation AOIF No. 14/2008 of 3 April 2008, published on 9 April 2008;
The regulation is a result of the public debate in Belgium in late 2007 and early 2008 regarding the NID. The debate arose in part because the NID was expected to have a greater budgetary impact than initially thought. Some argued that this was due to abuses of the NID by some taxpayers.

The aforesaid calculation however considered the equity as a relatively static fact. From the analysis made by the NBB it seems nonetheless that as an effect of the introduction of the NID regime, manifold companies have increased their equity substantially to benefit as much as possible from the deduction. The calculations made by the NBB show that the gross tax advantage of the NID in 2008 already amounted to EUR 4 mil. This gross amount has however to be reduced by the following elements.

- The compensating measures introduced at the occasion of the NID;
- An economic return;
- An effect of capital inflow in Belgium from abroad which wouldn't have occurred without NID;
- The substitution of effective interest payments with notional interests (debt vs. equity);
- The substitution of the coordination centers legislation by the NID regime;
- The deferral of use of NOL's;
- Et seq.

The National Bank arrived for the year of 2008 at a net cost between EUR 280 to 770 mil. but warns that a calculation is very difficult. At the same time does the NBB warn for an increase of the cost price in a scenario where the interest rates for 10-year linear Belgian government bonds (the so-called OLOs) would rise (eventually combined with other fiscal optimizing techniques). A rise of this aforementioned interest rate is (at the moment) however very unlikely (as also can be demonstrated by the fact that for assessment year 2011 the NID rate is capped at 3.8%, with an increased rate of 4.3%).

6. Abuse

From the beginning on, some members of the parliament have insisted on making the NID only available on the condition that the taxpayer meets a minimum employment or investment threshold. The government however has never responded to this question, not only since it risks infringing EU law but also would diminish substantially the effectiveness of the measure in an international competitive context.

Tax Regulation AOIF No. 4/2008²¹

In the course of 2008 the Belgian tax authorities started to react to alleged abuses. As a response on the critics a specific task force was created in 2008²². The tax administration also came up with an anti abuse tax regulation. The Tax Regulation AOIF No. 4/2008 is the government's attempt to encounter potential abuses on the basis of the current legislation. The regulation provides for the creation of a specific anti abuse team at the Central Tax Authorities and introduced a specific ad hoc service which is responsible for data mining to monitor important increases of equity, realization of important capital gains and important reduction of participations.

The main objective of the Tax Regulation AOIF No. 4/2008 lies however in discussing the existing anti-abuse provisions and how to apply them:

²¹ Tax regulation AOIF No. 14/2008 of 3 April 2008, published on 9 April 2008.

²² See also "Verslag over een aantal specifieke maatregelen tegen de fiscale fraude", Rekenhof, 9 December 2009, http://www.ccrek.be/docs/Reports/2009/2009_28_Fiscalefraude.pdf

Specific anti-abuse provisions in the NID law

It has to be pointed out that the NID law contains already some anti-abuse provisions, i.e. the deduction from the risk capital of unreasonable investments, passive investments and real estate used by directors (or family members). Also, as is described earlier, must the risk capital be reduced by certain shareholdings (financial fixed assets) to avoid the 'cascade' effect and to prevent companies from artificially increasing the computation base for the risk capital. The Tax regulation AOIF No. 14/2008 sees this change to the calculation base as a specific anti-abuse provision²³.

Abnormal or gratuitous advantages

Under Belgian tax law²⁴, certain tax deductions may not be subtracted from the profit derived from so-called "abnormal or gratuitous advantages", which are directly or indirectly received by the taxpayer from a dependant company. The NID is one of those deductions. What exactly constitutes such "abnormal or gratuitous advantage" is not defined by statute, but an extensive body of case law has interpreted and explained the term.

The Tax Regulation AOIF No. 4/2008 (and referring therefore to the decision of the ABM Internationaal, Belgian Supreme Court, 29 April 2005²⁵) provides that the tax administration has henceforth to verify if the profit from which a taxpayer deducted the NID originates from a transaction which involves "abnormal circumstances", i.e. which was undertaken purely for tax objectives, without having economic purposes²⁶. The NID will be denied on profits realized from such artificial transactions.

According to Tax Regulation AOIF No. 4/2008 this provision cannot be used to challenge legitimate transactions²⁷, i.e. if these transactions are based on legitimate business needs and not merely artificial transactions, solely performed with a fiscal aim. The tax administration de facto makes the judgment whether there are legitimate business needs and in case of such legitimate business reasons the anti-abuse provision will not apply due to the lack of 'abnormal or gratuitous advantages'.²⁸

The anti-abuse provision also won't apply to companies whose recognition as a coordination centre has expired and which continue to engage in their activities in the same entity or another entity which benefits from the NID.

Other initiatives

Moreover, in October 2009, a list which contains the names of ca. 30 companies which are suspected of NID fraud was handed over to the Belgian anti tax fraud force.

Besides do companies, when requesting an advance ruling, have henceforth to provide the advance ruling commission spontaneously with an estimate of the impact on the NID of the envisaged transactions.

²³ Haelterman A and Verstraete H, 'The Notional Interest Deduction in Belgium', *Bulletin for international taxation* 5(2008), pp. 362-373, at p. 371.

²⁴ Art. 79 BITC *juncto* Art. 207 BITC

²⁵ Hof van Cassatie, 29 April 2005, No. F030037N.

²⁶ E.g. from now on the contribution of assets could qualify as an abnormal transaction, with the result that the NID with respect to the profits generated by the contribution can be denied.

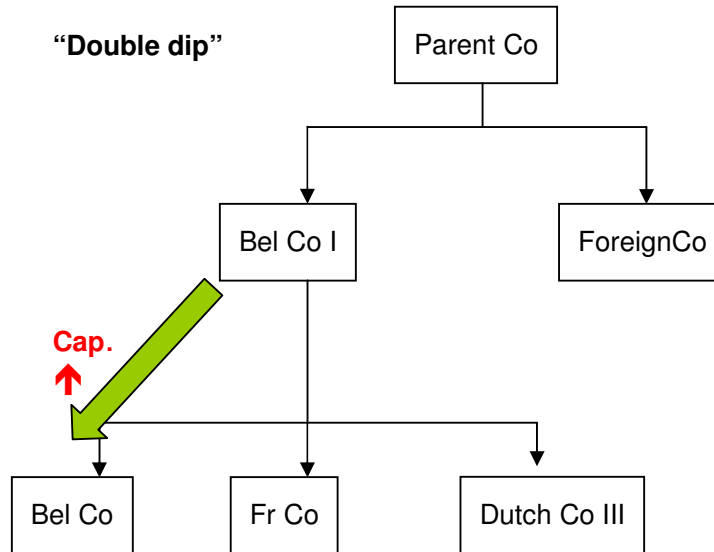
²⁷ E.g. centralizing financing or other activities in a specialized company since these transactions are based on legitimate business needs

²⁸ Haelterman A and Verstraete H, 'The Notional Interest Deduction in Belgium', *Bulletin for international taxation* 5(2008), pp. 362-373, at p. 372.

The effect of all the earlier mentioned efforts' is however all by all (very) limited

Two commonly applied techniques to optimize the NID are discussed hereafter:

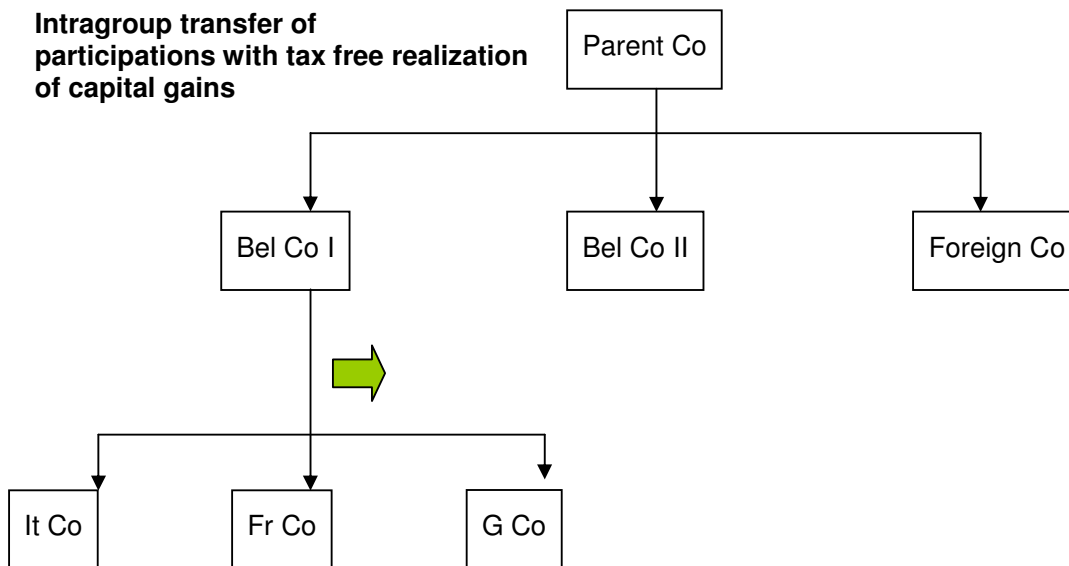
1. The first frequently applied technique was the so called 'double dipping':



One potential "abuse" of the NID is the "double dip" whereby a company takes out a loan, fiscally deducts the interest on it and uses the loan proceeds to increase the capital of a subsidiary, which then applies the NID based on the increased capital. On a consolidated basis, the two companies receive two tax benefits: the tax deduction of the interest paid on the loan and the NID based on the capital increase with the funds made available by the loan.

Notwithstanding that some call this an "abuse", this tax advantage appears rather to be an application of the (Belgian) law. Also Tax Regulation AOIF No. 4/2008 refers to the general rules applicable to the deductibility of interest, which provide that interest is deductible if the cost is incurred to obtain or retain taxable income (Art. 49 BITC). The regulation particularly refers to two requirements that have to be met in order that costs are deductible. First the costs must fall within the company's corporate purpose and second that the costs have to fall within the framework of the real and effective activities performed by the company.

2. The second frequently encountered technique was the artificial increase of equity:



Tax Regulation AOIF No. 4/2008 provides that if assets (e.g. shares) are sold, the tax authorities must check whether the consideration received equals the fair market value of the transferred assets and whether the payment mechanisms are at arm's length in order to prevent an artificial creation of own funds.

This condition was drawn up as a consequence of the intra-group reorganization which frequently took place following the introduction of the NID. Since the introduction of the NID, Belgian companies started to reorganize itself in a way that their holding activities were collated in a separate entity (and were separated from their operational activities). This may be done for example by selling the shareholding to another Belgian (with low equity) or foreign group company, which may "debt-leverage" the acquisition. As a result, the fiscal net value of the shareholding no longer reduces the NID calculation base and the profits realized from the sale increase the NID calculation base, and these capital gain on shares are tax exempt under Belgian law).

The Tax regulation AOIF No. 14/2008 seems to provide that such a sale is permitted under the condition that the consideration for the sale is at arm's length. As a consequence of this new provision the NID of Belgian entities with (substantial) holding activity may be substantially reduced²⁹.

7. Future

In its short history, the NID has proven itself to be a national and internationally attractive tax measure which distinguishes itself through the fact that it is not limited to a specific category of companies (such as the coordination centers) but is eligible for all companies. It can be assumed that the measure not only avoids some possible state aid issues within an EU context, but also seems to be efficient in situations where foreign CFC-rules possibly apply (i.e. in situations where a financing company is eligible for the NID, and this Belgian company also performs operational activities).

²⁹ The impact is even bigger on participations in non-Belgian entities, since, as was explained above, there is no possibility of a 'cascade'

From the beginning on this measure has however been highly controversial. Socialist parties blame the cost price. But the fact that those parties have approved this measure by giving it a supporting vote in the parliament may prevent them to plead straight off in favor of the abolition of the NID. If we go through the party lines of the different political parties issued at the last elections, almost none took the position that the NID had to be abolished. It nevertheless has to be mentioned that some political parties insisted on a better monitoring of the measure to ensure that the cost price stays within certain limits. Besides this do some other parties plead to link the eligibility of the NID to a minimum employment or investment condition, or to disqualify banks from the NID. It is needless to say that this conversely leads to an infringement of the non-discrimination principle within a European and constitutional context.

At the moment when this article was written (June 2011) the peace seems to have returned. The lack of a definitive government (at the moment Belgium is still governed by a government of pending cases) is of course not unrelated to this. Once a definitive government will be appointed, one of their first concerns will be to fill the budget gap of EUR 25 mil. An abolition of the NID therefore seems highly unlikely; however a stricter monitoring of the concrete application of the measure seems unavoidable.

To end this article, at all the politicians who are not so keen on the NID: calculate what impact a decrease of the corporate income tax rate of 33,99%, to for example the in the Netherlands applied rate of 25 %, would have as an impact on the budget. The result would be devastating. Nevertheless is the Dutch rate not linked to any employment or investment condition. The attempt made through the introduction of the NID to generate an effective tax rate at the level of the surrounding countries seems in a small and therefore economically very internationally focused country as Belgium, nothing more than a perfectly legitimate desire.

Article 205 bis

To determine taxable income, the taxable base is reduced by the amount set in accordance with Article 205quater. This reduction is called the "risk capital deduction."

Article 205 ter

Section 1. To determine the risk capital deduction for a taxable period, the risk capital in consideration corresponds to the total shareholders' equity of the company at the end of the previous taxable period, determined in accordance with the legislation concerning accounting and annual financial statements, as they appear on the balance sheet.

The risk capital determined in Paragraph 1 is reduced by:

- a) The net value for tax purposes at the end of the previous taxable period of the treasury stock and financial assets consisting of holdings and other stock and shares and
- b) The net value for tax purposes at the end of the previous taxable period of the shares or units issued by investment companies, the income from which qualifies for deduction from earnings by virtue of Articles 202 and 203.

Section 2. When the company owns one or more establishments abroad, the income from which is exempt by virtue of treaties to prevent double taxation, the risk capital determined in accordance with Section 1, is reduced by the positive difference between, on one hand, the net book value of the assets of the foreign establishments, except for

shares or units as set forth in Article 205 ter, Section 1, Paragraph 2, and, on the other hand, the total liabilities that are not part of the treasury stock of the company and which may be allocated to these establishments.

Section 3. When the assets of the company includes real estate located abroad and the rights related to these buildings, not related to a foreign establishment, and the income from these assets is exempt by virtue of treaties to prevent double taxation, the risk capital determined in accordance with Sections 1 and 2, is reduced by the positive difference between the net book value of these assets and the total liabilities that are not part of the treasury stock of the company and which may be allocated to this real estate or rights.

Section 4. The risk capital determined in accordance with Sections 1 through 3, is reduced by the following values, determined as of the end of the previous taxable period:

1. The net book value of tangible assets or a part of them, to the extent that the charges related to them unreasonably exceed occupational needs.
2. The book value of items held as investments which by their nature are normally not used to produce taxable periodic income.
3. The book value of real estate or other real rights to such assets when they are used by physical persons who carry out a mandate or duties as set forth in Article 32, Paragraph 1, Item 1, their spouses or their children, when these persons or their spouses have legal enjoyment of the income of these children.

Section 5. Furthermore, the risk capital determined in accordance with Sections 1 through 4 is diminished by the capital gains reported but not realized as set forth in Article 44, Section 1, Item 1, which do not bring research and development or capital contribution tax credits to the assets as set forth in Sections 2 through 4.

Section 6. When changes to the elements as set forth in Sections 1 and 3 through 5 occur during the taxable period, the risk capital to be considered is increased or diminished depending on the case by the amount of these changes, calculated as the weighted average and considering that the changes took place the first day of the calendar month following their occurrence.

The changes to the elements as set forth in Section 2 which occur during the taxable period are taken into conditions into consideration under the conditions and according to the procedures determined by the King by royal decree approved by the Council of Ministers.

Section 7. In applying Section 1 with regard to credit institutions as set forth in Article 56, Section 1, to insurance companies as set forth in Article 56, Section 2, Item 2 h), and to broker-dealers as set forth in Article 47 of the Law of 6 April 1995 on secondary markets, on the status and oversight of investment companies, and on investment intermediaries and advisers, "financial assets consisting of holdings and other stock and shares" means shares or units that had the nature of financial assets as set forth in Article 202, Section 2, Paragraph 2.

Section 8. For taxpayers subject to corporate income tax, to whom the Law of 27 June 1921 on not-for-profit associations, international not-for-profit associations and foundations applies, shareholder equity mentioned in Section 1 means company funds, as they appear on the balance sheet drawn up by these taxpayers.

Article 205 quater

Section 1. The risk capital deduction is equal to the risk capital determined in accordance with Article 205 ter, multiplied by a rate set in the following paragraphs.

Section 2. For fiscal year 2007, the applicable rate is equal to the average of the J-series benchmark indices (10-year government bonds) published monthly by the Fonds des Rentes [Public Securities Regulation Fund], as shown in Article 9, Section 1 of the Law of 4 August 1992 concerning mortgage credit, for the year 2005.

Section 3. For the successive fiscal years, the applicable rate is set with regard to the average of the J-series benchmark indices as set forth in Section 2 for the next-to-last year before the designated fiscal year.

The applicable rate to determine the amount of the risk capital deduction as set forth in Article 205bis may not vary by more than one point from the rate applied during the previous fiscal year, for each fiscal year as set forth in the preceding paragraph.

Section 4. By royal decree approved by the Council of Ministers, the King may decide not to apply the limit as set forth in Section 3, Paragraph 2, and to set another rate outside this limit to determine the amount of the risk capital deduction, but limited to the rate corresponding to the benchmark index J as set forth in Section 2 for the next-to-last previous year before the fiscal year involved.

Section 5. The rate determined in accordance with Sections 2 through 4 may not be more than 6.5%.

By royal decree approved by the Council of Ministers, the King may make an exception to the rate as set forth in Paragraph 1.

Section 6. For companies that in accordance with certain criteria in Article 15, Section 1 of the Company Code, are considered small businesses for the fiscal year linked to the tax period during which they benefited from the risk capital deduction, the rate determined in accordance with Sections 2 through 5 is increased by a half-point.

Section 7. By royal decree approved by the Council of Ministers, the King determines the procedures for calculating the risk capital deduction for the first taxable period of a company when the taxable period is greater or less than 12 months.

Article 205 quinquies

If there is a lack or insufficiency of earnings during a taxable period during which the risk capital deduction could be applied, the exemption not granted for that taxable period is carried forward to earnings for the following seven years.

Bernard Peeters and Thomas Hermie
Senior Partner and Associate
Tiberghien Lawyers