European Commission Questions Belgian Notional Interest Deduction

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European Commission Questions
Belgian Notional Interest Deduction

Four years after the introduction of a notional interest deduction to replace Belgium’s coordination center tax regime, which was repealed at the behest of the European Commission, the commission is questioning some limitations to the deduction.

Belgium’s favorable tax regime for coordination centers, which were used primarily to finance group companies, had a major role in the country’s popularity for international tax planning purposes.

When the European Commission ordered Belgium to repeal the advantageous tax regime, Belgium responded by introducing a deduction for risk capital (the notional interest deduction), saying it was needed to create a level playing field for debt and equity financing.

Under the regime, a Belgian company or a Belgian permanent establishment may deduct a notional interest based on its equity capital. The percentage of the deduction is linked to the interest rate paid by the Belgian Treasury on 10-year linear bonds. For 2009 the rate is 4.473 percent (4.973 percent for small and medium-size enterprises). The equity to be taken into account is the company’s share capital and its retained earnings, with some exclusions to avoid double dips and other unintended uses. The net equity in the assets of a PE or real property located in a tax treaty country is to be excluded from the equity.

The notional interest deduction can substantially lower the company income tax, reducing the average tax rate from 33.99 percent to about 25 percent, or much less if the company is highly capitalized. (For prior coverage, see Doc 2005-4639 or 2005 WTD 45-1.) The deduction makes tax-efficient group financing possible, as the interest income of a Belgian finance center can be fully or partially offset by the deemed interest deduction on invested equity. Since the deduction was introduced, the limitation on distributing the benefit of the deduction in the form of a dividend has been eliminated.

When the notional interest deduction was introduced in 2005, Belgian Finance Minister Didier Reynders confirmed that the European Commission had no objections because the deduction was available to all companies and even to Belgian branches of foreign companies (although limited to their Belgian equity).

However, the commission on February 19 addressed a letter to Belgium as a preliminary step toward an investigation into the compatibility of the notional interest deduction with the EC Treaty and European Economic Area Agreement. The commission does not condemn the notional interest deduction regime as such. Its position is that the exclusion of the net equity is in breach of the EC Treaty principles of freedom of establishment (for the equity in a foreign branch) and the free movement of capital (regarding real property). The exclusion of the net equity may dissuade Belgian companies from setting up a branch or investing in real property outside Belgium, the commission says.

It is asking Belgium to justify the limitations. The letter notes that there is no provision in the double tax treaties that addresses the notional interest deduction, and that the limitations (the exclusion of the net equity in both situations) do not result from the allocation of taxing powers between Belgium and the tax treaty country where the branch or real property is located.

Belgium’s justification is that the tax advantage is not granted when the equity does not generate taxable profit in Belgium. But the commission argues that the deduction is a lump sum and a fictitious advantage, and that there is no relationship between the fiscal advantage and some elements of income. The notional interest deduction stands on its own, the commission says.

Belgium has two months to justify the exclusions. Depending on the answer it provides, the commission may start an infringement procedure and issue a reasoned opinion asking Belgium to take the steps necessary to comply with that opinion within two months of its receipt. If the commission finds Belgium’s response to the reasoned opinion unsatisfactory, it can bring an action before the European Court of Justice.

However, it is unlikely that this will go that far. Most commentators expect an amendment of the Belgian legislation. Questioned in Parliament, Reynders

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said he did not exclude the possibility that the notional interest deduction would be extended to overseas branches and property.

A change in the law to allow a notional interest deduction for equity in tax treaty countries may not even have a big impact on the budget. Belgium may have to give a higher notional interest deduction to companies with properties outside Belgium. However, it is unlikely that foreign real property companies would move their head offices to Belgium to get the deduction because that would require them to move taxable profits into Belgium as well. And most Belgian companies with an overseas branch will have converted that branch into a subsidiary (under a sister company) so that they can deduct interest income in that subsidiary and neutralize the taxation with the interest deduction.

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