Belgian Government Finalizes Plans for Risk Capital Deduction

Posted on Mar. 9, 2005

Belgian Prime Minister Guy Verhofstadt and Finance Minister Didier Reynders on March 4 announced that the government has finalized its plans to introduce a fictitious, or notional, interest deduction to encourage companies to self-finance their investments and to strengthen their capital structure.

The new measure, which also would reduce the discrimination between equity and borrowed funds, is intended to replace the tax regime for coordination centers, which will expire at the end of 2010. Under the current regime, the interest paid on borrowed funds is a tax-deductible expense, and the withholding tax on that interest is limited to 15 percent. However, the return on equity contributed to shareholders in the form of share capital is not guaranteed, and distributed dividends are not tax-deductible for the company and are fully subject to corporate income tax. Moreover, the company must withhold tax at source at a rate of 25 percent. (The withholding tax rate can be reduced to 15 percent in two cases: if the share capital was issued after January 1, 1994, and the shares have been paid up in cash following a solicitation of funds from the public; or if the shares are either registered shares or bearer shares held in open deposit with a bank.)

Provisions Favoring Investments in Equity

Capital Tax Exemption

First, the government plans to abolish the 0.5 percent capital gains tax on contributions to a company's share capital. The tax is due when the company incorporates, and on the issue of new share capital.

Last year, when the government agreed to the new tax regime for coordination centers at the behest of the European Commission, one of the tax incentives withdrawn was the CGT exemption. At the time, the government had announced that it would reduce the CGT rate from 0.5 percent to 0.25 percent or 0.3 percent for all Belgian companies. (For prior coverage, see *Tax Notes Int'l*, May 24, 2004, p. 796, *2004 WTD 95-3*, or *Doc 2004-10451* [PDF].)

Under the government's new plan, that CGT would be abolished, except, presumably, for the contribution of a house or other residential accommodation by an individual to the share capital of a company. In that case, the CGT rate would be the same as for the purchase tax (12.5 percent, or 10 percent in Flanders).

Risk Capital Deduction

Furthermore, as of tax year 2007, Belgian companies would be able to take a deduction against their 2006 profits for the hypothetical interest they would have paid if they had financed their activities with borrowed funds.

A company would be able to set off against its taxable profits a percentage calculated on the company's risk capital -- that is, the company's share capital plus its retained earnings, less:

- the net book value of the shares the company holds in its own share capital;
- shareholdings that are not participations in affiliated companies, but are mere financial assets;
- the net book value of the assets of an overseas permanent establishment of the company, if the profits of that PE are tax-exempt under a double tax treaty;
- the net book value of real estate (or entitlements in real estate) held by the company abroad, if the income of those assets is tax-exempt under a double tax treaty; and
- the net book value of any other investment that is not acquired to produce a regular income, if the interest deduction for borrowings would have been disallowed on the basis that the investment clearly and unreasonably exceeded the needs of the company.

The figures to be taken into account would be those of the last set of annual accounts, but certain changes during the accounting year would be taken into account.

The notional interest rate would be the interest rate paid on 10-year linear bonds issued by the Belgian state, and it would be fixed every three years. The rate for profits for 2006, 2007, and 2008 would be the interest rate used at the end of 2005. The current rate is around 3.7 percent. Small and medium-sized enterprises would be entitled to an interest deduction that is a half percentage point higher. However, they may have to choose between the notional interest deduction and the investment reserve.[1]

To encourage start-up companies, the tax deduction could be carried forward for seven years. However, companies would have to retain the invested capital for at least three years.

Foreign companies would be entitled to the same deduction, but only for risk capital used for their Belgian PEs and Belgian real estate or real estate entitlements.

Verhofstadt is hoping that the Parliament will adopt the legislation by summer so that it can enter into force in 2006.

Cutbacks

The cost of the proposed new tax regime is estimated at approximately €500 million, but the government believes the notional interest deduction alone would generate about €100 million. That is because the measure presumably would attract equity and investments, which would generate jobs and profits, in turn leading to more corporate income tax, social security, and income tax on salaries. Furthermore, when profits are distributed, the company would pay withholding tax, and when the shareholders spend their dividends, they would generate VAT and excise duties.

Another €100 million would come from cutting back existing measures, such as the tax credit[2] introduced in 1996, and the investment deduction that took effect in tax year 2004, which served the same purpose. Those measures are limited to SMEs, are complicated, and usually are one-time benefits. Specific investment deductions for research and development, to encourage a rationalized use of energy, and for investments in security would be maintained.

Finally, the government expects to collect approximately €300 million from a modification of the tax treatment when a company obtains a capital gain on the sale of a shareholding. The principle would not change: The company would continue to enjoy the tax exemption for capital gains for shareholdings that qualify for the participation exemption for dividends received. However, the tax treatment of the transaction costs incurred by the company (brokerage fees, commission fees, and so on) has always been a bone of contention between Reynders and taxpayers.

According to tax authorities, the tax exemption is limited to the net capital gain (after the deduction of the transaction costs). If the exemption extends to the entire capital gain (before the deduction of the transaction costs), the company could set off those expenses against profits other than capital gains. The Court of First Instance in Namur[3] upheld the position taken by the tax authorities, while the Court of First Instance of Mons[4] and the Court of First Instance of Antwerp,[5] echoing a decision by the Court of Appeal in Antwerp, decided that the exemption should be extended to the entire capital gain. For now, the government plans to limit the tax exemption to the net capital gain, and to disallow the set-off of transaction costs.

The End of Bearer Securities

A ban on all bearer securities had already been announced in the summer of 2003, when the tax amnesty was put on the rails. (For prior coverage, see *Tax Notes Int'l*, Jan. 12, 2004, p. 115, *2004 WTD 4-4*, or *Doc 2004-257 [*PDF*]*.) But in the meantime Reynders had indicated that the ban no longer was a priority.

However, to win over the socialist parties in the federal government, he has promised that all bearer securities would be banned as of 2013. That would apply to shares, bonds, and cash bonds. During a transitional period from 2008 to 2013, no new bearer securities could be issued, and as of 2013, all investments would have to be registered so that the government could identify the owner.

CGT Exemption for Shares Maintained

The CGT exemption on the sale of a substantial shareholding in a Belgian company will be maintained. (For prior coverage, see *2004 WTD 244-1* or *Doc 2004-23818* [PDF].)

At the beginning of last week, it was rumored that Belgium would tax the capital gains on shares. But Verhofstadt and Reynders have confirmed that they do not want to attract equity to Belgium while discouraging investors by introducing a general CGT for private individuals and companies.

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FOOTNOTES

[1] Article 194 *quarter*, Income Tax Code 1992. This measure took effect in tax year 2004.

[2] Article 289 *bis*, section 2, Income Tax Code 1992.

[3] June 19, 2002, Fiscale Jurisprudentie/Jurisprudence Fiscale, 2002/255.

[4] September 11, 2002, Fiscale Jurisprudentie/Jurisprudence Fiscale, 2004/224.

[5] January 6, 2003, Fiscale Jurisprudentie/Jurisprudence Fiscale, 2003/188.

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