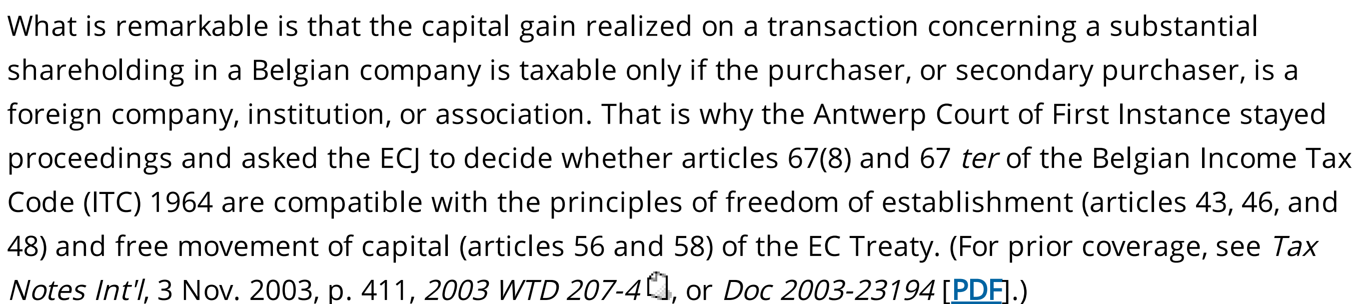
Belgium's Tax on Sale of Substantial Shareholdings to Foreign Entity Violates EC Treaty, Court Says

Posted on Jun. 28, 2004

European Court of Justice on 8 June issued a reasoned order in a preliminary ruling sought by the Antwerp Court of First Instance on the compatibility with EU law of Belgium's capital gains tax on the sale of a substantial participation in a Belgian company to a foreign entity (*De Baeck v. Belgian State* (Case C-268/03)). The Court found articles 67(8) and 67 *ter* of the Belgian Income Tax Code (ITC) 1964, which govern that taxation, to be incompatible with the principles of freedom of establishment and free movement of capital, as established in the EC Treaty.

Under Belgian income tax rules, capital gains realized from the sale of a substantial shareholding in a Belgian company to a foreign entity[1] are taxed at a rate of 16.5 percent.[2] That is an exception to the general rule that an individual is not subject to tax on capital gains realized on his private assets (securities, tangible assets, or real estate) if the gains are realized on transactions that are within the limits of the normal management of a private estate.[3]

A shareholding in a Belgian company is deemed to be substantial if an individual vendor or his close relatives directly or indirectly hold or have held a participation of more than 25 percent any time during the five years before the sale.



What is remarkable is that the capital gain realized on a transaction concerning a substantial shareholding in a Belgian company is taxable only if the purchaser, or secondary purchaser, is a foreign company, institution, or association. That is why the Antwerp Court of First Instance stayed proceedings and asked the ECJ to decide whether articles 67(8) and 67 *ter* of the Belgian Income Tax Code (ITC) 1964 are compatible with the principles of freedom of establishment (articles 43, 46, and 48) and free movement of capital (articles 56 and 58) of the EC Treaty. (For prior coverage, see *Tax Notes Int'l*, 3 Nov. 2003, p. 411, *2003 WTD 207-4*, or *Doc 2003-23194* [PDF].)

De Baeck, the appellant, had sold shares in Belgian companies belonging to the Antverpia group for about €45 million. Tax authorities claimed that the resulting capital gain was taxable because De Baeck's family had a substantial shareholding in the Belgian companies belonging to the Antverpia group, and the purchase was a foreign undertaking.

The ECJ believed the issue could be decided based on case law, and it applied the accelerated procedure of article 104(3) of its rules of procedure. It informed the Antwerp court, asked the litigants, EU member states, and the European Commission to submit their observations, and rendered a reasoned order.

The ECJ based its reasoned order on its judgment in the Swedish *X and Y* case (C-436/00),[4] in which it held that the refusal of a tax advantage on the grounds that the taxpayer transfers his holding in a company established in another member state is likely to deter the taxpayer's exercise of the right

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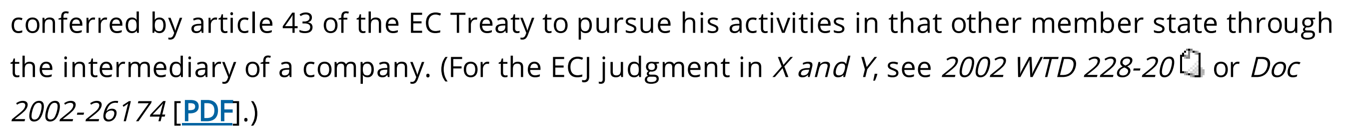

conferred by article 43 of the EC Treaty to pursue his activities in that other member state through the intermediary of a company. (For the ECJ judgment in *X and Y*, see *2002 WTD 228-20* or *Doc 2002-26174* [PDF].)

In *De Baeck,* the refusal of a tax advantage is more obvious than in *X and Y*. In that case, all the taxpayers were ultimately subject to CGT on shares transferred at undervalue, but taxpayers who held a participation in a domestic company could benefit from a tax deferral. That resulted in a cash flow disadvantage for a transferor who held a participation in a company established in another member state. In *De Baeck*, the transferor who assigns his shares to a company established in another member state pays CGT that he would not pay if he were to assign his shares to a Belgian company.

In *X and Y*, the ECJ made a distinction between individuals who have a major shareholding (that is, a holding that gives the individual definite influence over the decisions of a company established in another member state, and allows him to determine its activities) and those who do not. The Court held that in that context, that unequal treatment is a restriction on the freedom of establishment of nationals of the member state (article 43). In *X and Y*, the ECJ left it to the referring court to ascertain whether that condition was fulfilled.

If the referring court finds that the transferor has an inadequate degree of participation in the transferee company established in another member state, article 43 does not apply. However, the refusal of a tax advantage then constitutes a restriction on the free movement of capital under article 56 (*X and Y*, paragraph 70). In *X and Y*, that refusal is likely to dissuade those subject to CGT from transferring shares at undervalue to transferee companies in which they have a direct or indirect holding that are established in other member states.

The ECJ then deduced from its judgment in *X and Y* that the difference in treatment under articles 67(8) and 67 *ter* of the ITC 1964 that is detrimental to the taxpayer who assigns his shares or stock to taxpayers established in another member state constitutes a restriction on the freedom of establishment (articles 43 and 48).

The Court found that foreign taxpayers were likely to be restricted in exercising their right of establishment if they take a shareholding that gives the holder definite influence over the company's decisions and allows him to determine its activities. It is up to the Antwerp Court of First Instance to ascertain whether that is the case in *De Baeck*.

If the foreign taxpayer does not have a major shareholding, the difference in treatment under articles 67(8) and 67 *ter* of the ITC 1964 must be regarded as constituting a restriction on the freedom of movement of capital (article 56), inasmuch as the transfer of the shares or stock at issue to an assignee established in another member state is rendered less attractive.

The ECJ's preliminary ruling could have been easily anticipated in view of its case law in similar tax matters. The fact that the Court applied the accelerated procedure under article 104(3) of its rules of procedure and has given its decision by reasoned order indicates that the decision also is the opinion of the ECJ.

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The accelerated procedure used to be limited to situations when a question referred to the Court for a preliminary ruling was "manifestly" identical to a question on which the Court had already ruled. However, effective 1 July 2000, the rules of procedure were modified to allow the Court to decide through a reasoned order whenever "the answer to such a question may be clearly deduced from existing case law or where the answer to the question admits of no reasonable doubt."

In practice, the CGT on a substantial shareholding is not justifiable either. It discriminates against foreign purchasers because when they are bidding against a potential Belgian purchaser, they must offer about 22 percent[5] more than the Belgian bidder. There was an alternative, which was to incorporate a Belgian subsidiary as a vehicle for purchasing the Belgian company. That was an avoidance technique that was never questioned until recently.[6] However, even then the incorporation costs and administrative costs of operating the company would still put the foreign purchaser at a comparative disadvantage against a Belgian candidate.

Moreover, there is no justification for the different treatment of foreign purchasers. The CGT on substantial shareholdings was introduced in the income tax code in 1976, for situations when the shareholdings in a Belgian company were transferred to other Belgian companies. It was only in 1977, and to prevent abuses, that the tax was extended to transfers of shareholdings to foreign companies. The law was changed again in 1984 to exempt capital gains realized on the transfer of substantial shareholdings to Belgian companies, to facilitate initial public offerings. However, that does not justify the discrimination, as it does not pursue a legitimate objective compatible with the EC Treaty and is not an overriding general-interest ground. It seems the Belgian government decided it would not even submit that argument as a justification.

This ECJ decision should have a major effect on the negotiation of mergers and acquisitions, and the listing of Belgian companies on the stock market. Moreover, if the ECJ decision had been issued sooner, there would never have been an *Artwork Systems* case (for prior coverage see *Tax Notes Int'l*, 23 Feb. 2004, p. 713, *2004 WTD 32-13*, or *Doc 2004-3170* [PDF]), which was the result of an attempt by shareholders to set up a complex structure to avoid the CGT on substantial shareholdings.

Observers can only wait and see how the Belgian state will react. In a worst-case scenario, rather than exempting all capital gains from the CGT on substantial shareholdings, it will extend the tax to all capital gains on substantial shareholdings, regardless of whether the purchaser is a Belgian company or a foreign company.

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FOOTNOTES

[1] That provision is now article 90(9), ITC 1992. Before 1992, the provision was split over articles 67(8) and 67 *ter*, ITC 1964, which are the provisions dealt with by the Court.

[2] Article 171(4e), ITC 1992.

[3] Article 90(1), ITC 1992.

[4] ECJ, 21 November 2002, Case C-436/00 *X and Y* [2002] ECR I-10829, paragraph 36.

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[5] On top of the 16.5 percent CGT, the taxpayer also has to pay a local tax of about 6 to 9 percent, bringing the total tax bill for the beneficiary to about 18 percent of the sales price.

[6] Court of First Instance, Brussels, 18 February 2004 (nyp). The court decided that the Belgian subsidiary of a French company purchasing the shareholding was but a nominee in order to avoid the CGT. The subsidiary received an advance to buy the shares, but it did not have any documents related to the purchase, and it sold the shareholding after 12 months.

END OF FOOTNOTES

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