Courts Deal Belgian Tax Authorities Setback on Foreign Tax Credit Transactions

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Recent rulings by the Courts of First Instance of Mons and Brussels have thrown cold water on Belgian tax authorities' cases against companies it has accused of misusing foreign tax credits to avoid corporate income tax liability.

When a Belgian company receives interest from a foreign source, the payer usually has to withhold tax at source, at rates varying from 0.5 percent to 30 percent. When the company declares the interest it received, it cannot set off the tax withheld by foreign tax authorities against its Belgian income tax bill.

However, Belgium does provide some unilateral relief against that form of double taxation by granting a foreign tax credit[1] to companies that can prove that tax has been withheld at source on foreign-source investment income (other than dividends). The foreign tax credit is granted on the assumption that the tax collected at source was 15 percent, regardless of the level of tax actually withheld abroad.

Until 1990, the credit was calculated at 15/85ths of the net interest collected and was added to the interest and the grossed-up interest included in the company's taxable income. The foreign tax credit then could be set off against the corporate income tax due by the beneficiary, but if there is any excess, that excess cannot be refunded.

The law did not make a distinction as to the percentage or the amount of tax effectively withheld at source, which often proved very beneficial for the interest-recipient company. Even if the tax withheld at source was minimal, the company still was able to set off the full foreign tax credit of 15/85ths against its corporate income tax liability.

Background

In the mid-1990s, the antifraud department of the Belgian Ministry of Finance announced that it had uncovered a major scandal in which nearly all of Belgium's banks had been selling Italian, Korean, and Uruguayan bearer bonds and cash certificates to their clients, allowing them to make maximum use of the foreign tax credit to reduce or wipe out their corporate income tax liability. Tax authorities suspected that the number of bonds and cash certificates purchased largely exceeded those available and that in many cases the transactions were fictitious.

Initially, the foreign tax credit was used by the banks only for their investments abroad, but at the end of the 1980s, they turned it into a product that they marketed to their clients. By combining a high interest rate, the foreign tax credit, capital losses, and losses on the sales of the bonds and certificates, some banks were able to cancel out the corporate income tax due on their clients' business profits. The banks charged a percentage of the tax savings realized by the company, and that fee was tax-deductible.

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Italian bonds and cash certificates were particularly attractive because at that time, the double tax treaty between Belgium and Italy also provided for a form of tax credit. Article 23, paragraph 2 stated: "Subject to paragraphs 4 and 5 hereinafter, when a resident of a Contracting State receives income which, according to the provisions of article 11, paragraphs 2 and 6, has effectively been assessed in the other Contracting State, the first State shall grant on the tax due on this income by said resident a deduction equal to 15 percent of the amount of the above mentioned income which is included in the basis that is taxable in the hands of this resident."

In 1990 the law was amended to limit the foreign tax credit based on the period of time during which the company has held the foreign investments (for example, if the company has owned the assets for only three months in any year, it can claim only 3/12ths of the tax credit), and in 1993 a further limitation was introduced to limit the tax credit as it relates to the company's financing with loans.

With the discovery that nearly all Belgian banks had been using foreign tax credit transactions on an almost industrial scale, both for themselves and for their clients, the antifraud department realized that it had no legal recourse against the banks. But it soon found an answer in the tax on stock exchange transactions, which is due on the purchase or sale in Belgium, through a professional intermediary, of existing bond or Treasury certificates and is calculated at 0.07 percent.

Tax authorities accused the banks of selling the bonds and certificates via their foreign subsidiaries to circumvent the tax on stock exchange transactions. The antifraud department examined more than 1,000 cases involving some of Belgium's biggest companies, and in two operations ironically dubbed "O Sole Mio" and "Chicago," Belgian police raided the offices and private residences of several bank managers.

The foreign tax credit mechanism is estimated to have cost the Belgian Treasury about €375 million in corporate income tax. Many banks have since settled the tax and negotiated amounts to be paid in fines. Criminal prosecutions also have been launched against 17 banks and about 25 bank managers, but those court cases have not yet begun.

While many companies settled, most appealed to the tax director, who postponed a decision in many cases, presumably because the tax authorities were preparing their arguments before the courts and were waiting for a few favorable decisions.

However, the two recent court decisions may prove that the companies that decided to fight back have been right all along.

Court Decisions

The Court of First Instance of Mons was the first to hand down a decision on the foreign tax credit, on 20 June. Less than a week later, on 26 June, the Court of First Instance of Brussels followed suit.

The facts submitted to the Court of First Instance of Brussels are a good example of the tax benefit many companies were enjoying from the foreign tax credit. In 1989 a company purchased Italian Treasury bonds issued about a week before their maturity dates. It paid about €10.75 million for bonds with a nominal value of €10 million, taking account of the fact that they would mature soon afterward. The company collected about €1.1 million in interest after the deduction of a small

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amount of Italian withholding tax (6.25 percent at the time). A couple of days after the transaction, it sold the bonds for about €9.7 million. The result for the company was negligible; it made minimal profit from the difference between the interest paid and the interest collected.

The company claimed a deduction for expenses of about €150,000 for bank charges, and a foreign tax credit of about €275,000, to be set off against its corporate tax liability. The tax credit was calculated for the full 15/85th of the net interest collected, although the tax withheld in Italy was only 6.25 percent.

Tax Authorities' Arguments

The major argument put forward by tax authorities in both cases was that the transactions (purchasing bonds, collecting the interest, and reselling the bonds) were entirely simulated for the sole purpose of wiping out the companies' taxable profits. Consequently, they said, the companies did not meet the basic condition for an expense to be allowed (that is, that the expenses must have been incurred in order to acquire or maintain taxable income[2]). That condition is based on the income tax rules for individuals, but a commercial company generally is deemed to be in compliance with it as long as its expenses relate to activities within the company's corporate mission.

Tax authorities argued that the transactions did not fall within the companies' activities, so they could not claim a tax credit based on income from those transactions. Authorities argued that they had the right to disregard the simulated transactions and to tax the real, concealed transactions. However, they were never able to pinpoint exactly what the concealed transactions were.

Appearing before the Brussels court, tax authorities also tried to use a treaty argument to make the Belgian legislation more restrictive. The Belgian income tax provision that says the foreign tax credit is granted if tax has been withheld abroad should be interpreted in light of the provisions of the Belgium-Italy double tax treaty, they said. However, the court responded that an international treaty cannot limit advantages granted to a taxpayer and is intended only to limit the taxing powers of the signing states.

Courts' Conclusions

After a detailed examination of the various arguments put forward by tax authorities, the Brussels court concluded that the company's transaction was not simulated, even if the transactions were not meant to generate a profit. It suffices that the company intended to collect taxable income (the interest), which was the case, the court said.

The Mons court stressed that the condition that the expenses must be incurred to acquire or maintain taxable income relates only to the deduction of expenses, not to the offset of a tax credit against a company's tax liability. There is a specific provision that links the foreign tax credit to a company's business activities, but the court sidestepped that issue, saying that in any event, the double tax treaty between Belgium and Italy takes precedence, and any other conditions imposed under national law cannot restrict an unconditional tax credit that Belgium has provided in a treaty.

The Mons court said the company invested capital and received income, and the income could only be qualified as interest, which entitled the company to the tax credit. Therefore, it said, the company legally benefited from a favorable provision of international law that allowed it to set off a tax credit under conditions that were not particularly restrictive.

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Tax authorities' claim that the company purchased a consumer good and paid the bank a commission fee for setting it up also was rejected, particularly by the Brussels court. Even if that analysis reflects the economic reality, it does not correspond to the legal analysis of the transactions, which contradict that economic reality, the court said. The fact that the transactions had been recommended by, or even set up with the help of, a bank to obtain a fiscal advantage does not allow tax authorities to reject the income qualification, it said.

The Mons court rejected another argument that the ownership of the certificates had never been transferred, saying that the accounting rules used by the company, and the alternative accounting rules that tax authorities say the company should have used, both assume that the company was indeed the owner of the certificates.

Tax authorities also tried to demonstrate that each transaction constituted a single sale and repurchase agreement (REPO), but the Brussels court rejected the allegation that this meant that the company had not become the owner of the shares at the time the interest was paid out.

Another line of attack was that the purchase and sales operations were fictitious because the bank had infringed its obligations regarding the tax on stock exchange transactions. Before the Brussels court, tax authorities attempted to prove that the company had avoided the stock exchange tax, but they produced no evidence other than documentation that the bank had signed a settlement agreement and paid the tax. Authorities failed to explain why or on what basis the bank had settled.

The Mons court pointed out that tax authorities cannot simultaneously claim the tax on stock exchange operations and take the position that the certificates had not changed owners. Both courts also pointed out that for the tax on stock exchange transactions, the bank, and not the taxpayer, is the investor.

Final Comments

Tax authorities have tried to open a broader political debate as to whether fiscal engineering is legitimate, but the courts steered clear of that discussion to focus on the legal issues. However, one thing is clear: If there were favorable provisions in domestic and international law that allowed the company to set off a tax credit under conditions that were not particularly restrictive, the company legally benefited from those provisions.

The courts' decisions confirming that the transactions were legitimate is a major setback for Belgian tax authorities in their fight against foreign tax credit transactions and will undoubtedly encourage companies that have decided to fight back. Transactions involving Korean or Uruguayan certificates may be viewed less favorably, but the majority of cases are similar to the ones submitted to the courts in Brussels and Mons.

It is probably nothing more than a coincidence that both courts' judgments were rendered at the same time, but it is remarkable how both decisions complement each other, and it will make it all the harder to find arguments to appeal them.

Nevertheless, that is exactly what tax authorities have announced they will do. They appear to be focusing on one consideration in the decision of the Mons court -- namely, that no criminal prosecution had been filed against the company or its directors for using what it contends were

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forged or counterfeited documents. That is why companies that have appealed tax claims over use of the foreign tax credit risk being indicted in the near future. Whether this will add anything to the debate is doubtful; it only risks clogging up the judiciary system.

This is probably the largest tax fraud case ever launched in Belgium, and it may well become a case study as to how the taxman makes a case against a group of taxpayers and persuades a number of them to settle before seeing his case rejected by the courts.

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FOOTNOTES

[1] Article 187, paragraph 1, Income Tax Code 1964, which corresponds to article 285, paragraph 1, Income Tax Code 1992.

[2] Article 44, ITC 1964/article 49, ITC 1992.

END OF FOOTNOTES

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