ECJ to Examine Belgian Capital Gains Tax on Substantial Shareholdings

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The Antwerp Court of First Instance has sought a preliminary ruling from the European Court of Justice concerning the compatibility with EU law of the Belgian capital gains tax on the sale to a foreign entity of a substantial participation in a Belgian company.

One of the basic principles of the Belgian income tax is that an individual is not subject to tax on capital gains realized on his private assets (securities, tangible assets, or real estate) if those gains are derived from transactions that are within the limits of the "normal management of a private estate."[1] The courts have defined "normal management" as a conservative, risk-averse, and uncomplicated approach to the ownership of a private estate.[2] If that is not the case, and the capital gain is, rather, the result of speculation, the gains on an individual's private assets are subject to income tax at a flat rate of 33 percent.[3]

A sale of shares in a privately owned company usually constitutes normal management, so the resulting capital gains generally are tax-free.[4] However, capital gains realized as a result of the sale to a foreign entity[5] of a substantial shareholding in a Belgian company are taxed at a rate of 16.5 percent, even if the shares were sold "in the course of the normal management."[6]

A shareholding in a Belgian company is deemed to be substantial if an individual vendor and his close relatives hold, or have held, a direct or indirect participation of more than 25 percent at any time during the five years before the sale. Even the sale of a single share may trigger the 16.5 percent tax if that share was part of a substantial shareholding during the previous five years. In any event, the capital gain is taxed only when it is actually realized.

A specific antiavoidance clause has been tagged on to that provision: Even if the basic requirements referred to above are met, and the shares in the company are sold to a Belgian entity, the tax still becomes due if the purchaser transfers those shares to a foreign entity within 12 months of the initial sale.[7]

That tax liability does not apply solely to Belgian vendors selling to a foreign entity, but also to foreign (individual) vendors.[8] The latter usually can invoke the provisions of a double tax treaty to prevent Belgium from taxing their capital gains on shares, if they are not resident in Belgium. However, Belgium's existing double tax treaties with Mexico and Canada allow Belgium to tax Mexican resident and Canadian resident individuals' capital gains on substantial shareholdings in Belgian companies.

Notably, the capital gain is realized on a transaction related to a substantial shareholding in a Belgian company only if the purchaser, or secondary purchaser, is a foreign company, institution, or association. It is, therefore, common practice for a foreign group to acquire family-owned shares in a company via a Belgian company that it has recently incorporated for that purpose. Belgian tax authorities have not yet attacked such avoidance techniques. Nor would it appear that they can use the general antiavoidance rule found in section 1, article 344 of the Income Tax Code (ITC) 1992 against the avoidance strategy, as the law specifically permits it.

However, vendors sometimes are unable to convince the purchaser to acquire its shareholding via a Belgian company. That was the case in March 1989, when the De Baeck family of Antwerp sold its participation in the insurance company Antverpia for €45 million to the French Sociéte Europeenne de Finances en d'Assurances. The vendors say the purchaser's intentions were not entirely honorable; the company was plundered and barely escaped bankruptcy. However, Antverpia has survived and currently belongs to the Dutch Delta Lloyd group, part of the CGU insurance group.

The tax authority sent the family a CGT bill, which they contested. One of their arguments was that the "foreign purchaser" provision was archaic and no longer could be justified within the European Union. They said the provision discriminated between shareholders who sell their shareholding to a Belgian company and those who sell their shareholding to a company established in another EU member state. In particular, that is contrary to the principle of freedom of establishment, they said.

In an interim judgment of 13 June, the Antwerp Court of First Instance stayed the proceedings and turned to the ECJ for a preliminary ruling on whether articles 67(80) and 67 ter of the ITC 1964 are compatible with the principles of freedom of establishment (articles 43, 46, and 48) and the free movement of capital (articles 56 and 58) of the EC Treaty.[9]

In recent years, the ECJ has become more assertive in exercising its right to examine the domestic legislation of EU member states in light of the EC Treaty, when the provision at issue is a matter of tax law. Considering previous case law, one possibly could anticipate what the Court is going to say in *De Baeck v. Belgium* (C- 268/03).

According to ECJ case law, although direct taxation remains within their competence, EU member states must nonetheless exercise that competence consistently with EU law and particularly must avoid any discrimination on grounds of nationality.[10] Having made that declaration, the ECJ in previous cases then examined whether there was an obstacle to the freedom of establishment and a difference in the treatment of resident and nonresident companies.

Because existing double tax treaties generally prevent Belgium from taxing foreign individuals resident in another EU member state, the law in dispute seems only to discriminate in favor of one Belgian resident over another Belgian resident, based on the residence of the subsequent purchaser of the resident's shareholding in a Belgian company. And the *De Baeck* case only confirms that impression. De Baeck is complaining only because he has to pay the tax. He could, however, argue that he is being discriminated against, as he is suffering for his choice of doing business with a non-Belgian company.

Nevertheless, it is essentially the foreign purchaser who is the object of discrimination. If he is bidding against a potential Belgian purchaser, he has to add about 18 percent[11] to the price he offers in order to cover the CGT that the vendor will face. Admittedly, he could easily get around the issue by incorporating a Belgian subsidiary as a vehicle for purchasing the Belgian company. However, the incorporation costs and the administrative cost of operating the company still would put him at a comparative disadvantage, compared with a Belgian candidate.

Such a difference in treatment between resident and nonresident companies would constitute an obstacle to the freedom of establishment, which is, in principle, prohibited by article 43 of the EC Treaty. The tax measure makes it less attractive for companies established in other EU member states to exercise their freedom of establishment, and as a result, they may refrain from acquiring, creating, or maintaining a subsidiary in the state that adopts that measure.[12] It is hard to imagine how Belgium could justify the difference in treatment.

Therefore, it is likely that the ECJ will hold that the CGT on substantial shareholdings established by the Belgian legislation in dispute is not compatible with the principle of freedom of establishment. One also could argue that the Belgian tax provisions restrict the free movement of capital, as the non-Belgian company is penalized for seeking to purchase shares in a Belgian company.

If the Belgian tax is deemed illegal, it will have a major effect on the negotiation of mergers and acquisitions and the listing of Belgian companies on the stock market. Moreover, there never would have been an *Artwork Systems* case (for prior coverage, see *Tax Notes Int'l*, 6 Jan. 2003, p. 21, *2002 WTD 247-3*, or *Doc 2002-27961 (4 original pages)* [PDF]), as the shareholders would not have had to set up a complex structure to avoid the tax.

However, one should not exclude the possibility that Belgium's next move will be to change the law in order to tax all capital gains on substantial shareholdings, regardless of whether the purchaser is a Belgian or foreign company.

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FOOTNOTES

[1] Article 90(10) Income Tax Code 1992.

[2] Antwerp, 18 November 1997, *Fisc. Act.*, 1998/2,4; Antwerp, 2 February 1993, *F.J.F.*, 93/186; Luik, 19 December 1991, *Bull. Bel.*, 723, 121; *Fiskoloog* 1993, 421, 11.

[3] Article 171(l0a), ITC 1992.

[4] Recent tax audits suggest that the tax authorities are taking the position that a transfer of shares to a controlled company may not qualify as normal management.

[5] Article 90(90) ITC 1992. That provision used to be divided among articles 67 (80) and 67 ter of ITC 1964, which were the provisions dealt with by the Court.

[6] Article 171(40e) ITC 1992.

[7] Article 94 ITC 1992.

[8] Article 228, section 2(90h) ITC 1992.

[9] C-268/03.

[10] Case C-80/94, *Wielockx* (1995) ECR I-2493, paragraph 16; case C-107/94, *Asscher* (1996) ECR I-3089, paragraph 36; *Royal Bank of Scotland*, cited above, paragraph 19; *Baars*, cited above, paragraph 17; and joined cases C- 397/98 and C-410/98, *Metallgesellschaft and Others* (2001) ECR I-1727, paragraph 37.

[11] On top of the 16.5 percent CGT, the taxpayer also has to pay a tax of about 6 to 9 percent to local authorities, bringing the total tax bill to about 18 percent.

[12] See Case C-324/00, *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, 12 December 2002, (2002) ECR, I-11779, paragraph 42.

END OF FOOTNOTES