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I. Introduction – definition – tax treatment – dividend versus interest

There are broadly two ways of financing a company. One is by issuing shares in equity capital and the other is by borrowing. Equity capital includes the company's issued share capital, its retained profits and the reserves. Loan financing includes all forms of interest-bearing indebtedness. The distinction between the two forms of financing is not always clear, particularly in the area of hybrid financing.

Thin capitalization refers to those companies which have a high proportion of debt financing in relation to equity capital. Where interest is allowed as a tax deduction, a high ratio of debt versus equity means that a large part of the company's profits is being paid out as tax-deductible interest rather than non tax-deductible dividends. Tax Administrations consider this practice as an unlicensed leakage of tax revenues. By the requalification of (part of) the loan as equity, thin capitalization regulations prevent the leakage.

Thin capitalization rules are normally defined as specific rules intended to requalify a loan, granted by a *shareholder*, as an equity contribution (or requalify interest as dividend) by enforcing a fixed maximum debt to equity ratio. Such rules do not exist in the Belgian tax legislation, although one could argue that article 18, 3° ITC should be considered as a measure against thin capitalization.[1] Due to the absence of thin capitalization rules as traditionally defined, I would rather comment on the broader topic of requalification of debt-instruments as capital contribution in the Belgian tax legislation.

The payment of excessive interest above the market rate and the tax consequences of the excessive part as a non tax-deductible expense and/or as a requalified dividend distribution will not be discussed in this report. Reference is made to another IFA report.[2]

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1 B. Peeters, "Het OESO-rapport inzake thin capitalization en het Belgisch fiscaal recht", *Tijdschrift voor Rechtspersonen en Vennootschappen*, 1989, No. 2, 113 and 117.

2 Article 55 Belgian Income Tax Code 1992 (abbreviated as ITC) and article 18, 3° ITC (first paragraph and first reference). M.-C. Sibille-VanGrieken, "Deductibility of interest and other financing charges in computing income", Belgian report for IFA Toronto Congress 1994, Kluwer, The Netherlands, 85.

In the Belgian tax law, an interest payment is a tax-deductible expense for a company unlike dividends paid which represent a distribution of the taxable profits of a company. For a company, interest received is a taxable item while any Belgian withholding tax retained on the interest can be offset against corporation tax in relation to the holding period of the loan.[3] The retained Belgian withholding tax is refundable when there is no or too little corporation tax in order to offset the withholding tax. In relation to the withholding tax on foreign interest, a foreign tax credit can be offset against the corporation tax under a few conditions.[4] This foreign tax credit is not a refundable item.[5] For dividends received by a company, the tax base is reduced to 5 per cent of the gross amount, if the conditions of the dividend exemption system are fulfilled.[6] The capital gains on shares are totally exempt under the same conditions of the dividend exemption system.[7] The capital losses and reductions in value of shares are not tax-deductible, unless the subsidiary is liquidated.[8] Losses and definite reductions in value of claims are tax-deductible expenses.

For a Belgian resident individual, the income of movable capital is definitively taxed by way of a "liberating" withholding tax. The withholding tax on interest is 13.39 per cent (13 per cent plus a crisis tax of 3 per cent).[9] The withholding tax on a dividend is generally 25.75 per cent (25 per cent plus 3 per cent), but the rate of 13.39 per cent applies for dividends of newly subscribed capital.[10]

One can conclude that the major consequences of the requalification of loan as capital for Belgian companies are the non-deductibility of the requalified paid interest for the borrower and the non-deductibility of the capital losses and reductions in value of the requalified loan for the lender. Especially for individuals, a higher rate of withholding tax due to the new character as dividend, is the major consequence.

In Belgium the corporation tax rate is relatively high and equals 40.17 per cent (39 per cent plus 3 per cent). Medium-sized and small companies with a majority of individual shareholders tend to have a very low level of capitalization since the global tax pressure on dividends (corporation tax and a withholding tax of 25.75 per cent) is much higher than the tax pressure on interest (no corporation tax and a withholding tax of 13.39 per cent). Particularly article 18, 3° ITC, as further discussed, is intended to counteract the tendency to thin capitalization.

3 Article 280 ITC.
4 Article 287 ITC.
5 Artide 292 ITC.
6 Articles 202, 203 and 204 ITC-DB I or RDT system (*definitief belaste inkomsten – revenues définitivement taxées*) These conditions are, broadly, a minimum level of participation of 5 per cent or an acquisition price of BEF50 million, and a minimum level of taxation in the subsidiary which distributes the dividends. Additionally, there are several anti-avoidance regulations.
7 Article 192 ITC.
8 Article 198,7° ITC.
9 The liberating withholding tax on interest of 13.39 per cent applies to debt instruments issued from 1 March 1990 (before that date, the rate of 25.75 per cent is valid).
10 Law of 30 March 1994, article 20. In the Budget Speech of the Belgian Prime Minister of 3 October 1995, he declared that the withholding tax rates of 13.39–25.75 per cent would be replaced by 15–25 per cent.

From an international point of view, debt financing yields a higher tax return for a Belgian subsidiary of a foreign parent company established in a country with a corporate tax rate lower than 40.17 per cent. For a Belgian parent company with a foreign subsidiary established in a country with a corporate tax rate lower than 40.17 per cent, equity contribution yields a higher after tax return if the received dividends benefit the tax exemption, according to article 202 ITC. As a consequence, the question arises, while commenting on the requalification of debt as equity, whether excessive capital contributions ("fat capitalization")[11] and the requalification of equity as loan, should bear any attention in the Belgian international tax area. A different section in this report deals specifically with "fat capitalization".

Another, rather minor, difference in tax treatment between loan and capital, is a registration duty of 0.5 per cent for any contribution of cash or in kind to the risk-bearing capital of a company, in exchange for shares. Increases of capital by new contributions in cash or in kind are subject to the same registration duty of 0.5 per cent as the formation of capital. There is no registration duty for a loan. This topic will not be discussed further in the report.

II. Non-tax-related aspects

The most important forms of business enterprise are the "*naamloze vennootschap – société anonyme*" (NV-SA) or public company, and the "*besloten vennootschap met beperkte aansprakelijkheid – société privée à responsabilité limitée*" (BVBA-SPRL) or private limited liability company. There are other business forms recognized by Belgian Company Law, such as the general partnership ("*vennootschap onder firma – société en nom collectif*", VOF-SNC), the limited partnership ("*gewone commanditaire vennootschap – société en commandite simple*", GCV-SCS), the partnership limited by shares ("*commanditaire vennootschap op aandelen – société en commandite par actions*" CVA-SCA), the limited cooperative company ("*coöperatieve vennootschap met beperkte aansprakelijkheid – société coopérative à responsabilité limitée*", CV-SC) and the unlimited cooperative company ("*coöperatieve vennootschap met onbeperkte en hoofdelijke aansprakelijkheid – société coopérative à responsabilité illimitée et solidaire*", CVOHA-SCRIS).

The NV must have a minimum paid-up capital of BEF 1,250,000. In addition, the capital of the NV must be fully subscribed and 25 per cent of each share of stock must be paid up. Shares representing a contribution in kind, even partly, must be paid up within five years after incorporation.[12] As and from 1 July 1996 at the earliest, the minimum paid-up capital amount will be brought to BEF2,500,000. The same regulation applies to the partnership limited by shares

11 F.C. De Hosson, "Verdragsrechtelijke aspecten van de Thin Capitalisationproblematiek", in *Eenvoud en doeltreffendheid, Liber Amicorum J. T. Warnaar*, 103.

12 Article 29, §1, §2, §5 Companies Law – for the chapter II with assistance of P. Rooryck, Legal Department, Kredietbank NV.

(CVA).[13] The BVBA must have a minimum capital of BEF750,000, of which at least BEF250,000 must be paid up. The capital must be fully subscribed.

Shares of the BVBA representing contributions in cash must be paid up for at least 20 per cent, shares representing contributions in kind must always be fully paid up.[14] The CV must have a minimum capital of BEF750,000, of which at least BEF250,000 must be paid up. 25 per cent of each share of stock of the CV must be paid up.[15] If part of the capital has not been (validly) subscribed to or the minimum amount has not been paid up, liability will pass to the founders of the NV, CVA, BVBA or CV, who are then considered subscribers of the unsubscribed capital and/or are obliged to make the minimum payments.[16] There are no minimum capital requirements for general partnerships, limited partnerships and unlimited co–operative companies. The public company and the partnership limited by shares are capital companies. The other four legal forms of a company are private companies.

Belgian financial regulations also prescribe minimum capital requirements for financial institutions. To get a Banking license for a new company, a minimum fully paid-up capital of BEF250,000,000 is required. For existing companies, the reserves and share premiums are taken into account, as long as the actual share capital amounts to BEF100,000,000.[17] The law of 6 April 1995 sets new rules for stockbrokers. It stipulates a BEF 10,000,000, 50,000,000 (if the broker acts for its own account) or 100,000,000 (if the broker acts as a custodian for insurance companies or mutual funds) minimum capital requirement.[18] Article 1 of a Royal Decree of 5 August 1991 sets minimum capital requirements for asset management companies (BEF10,000,000) and investment consultants (BEF2,500,000). For Investment Funds a minimum capital of BEF50,000,000 is required.[19] There are no minimum capital requirements for insurance companies.

Coordination centers are regulated by Royal Decree 187 of 30 December 1982. The coordination center must be part of an international group of companies. There are no specific minimum capital requirements for the coordination center itself except the general requirements if formed as a NV or BVBA. Nevertheless one of the conditions to obtain a license is that the consolidated equity capital of the group should equal at least BEF 1 billion and that the consolidated capital of the group outside Belgium should amount to at least BEF500 million or 20 per cent of the consolidated capital of the entire group.[20]

The Royal Decree of 5 August 1991 prevents excessive capital contributions by a Belgian parent company which the legislator designates as an abuse of the tax

13 Article 8, Law of 13 April 1995 (Belgian Gazette – abbreviated as B.G. – 17 June 1995; the Belgian Government has the power to postpone the new capital requirement by one year; article 107, Companies Law (CVA).

14 Article 120, 2°, 3°, 4°, 5°, 6° Companies Law.

15 Article 147bis, gl, §2 Companies Law.

16 Articles 35 (NV), 107 (CVA), 123 (BVBA), 147ter (CV) Companies Law; S. Huysmans, "Oprichtersaansprakelijkheid wegens onderkapitalisatie", *Balans*, No. 303, 30 June 1995, 7.

17 Article 16 Banking Law of 22 March 1993, B.G. 19 April 1993.

18 Article 58, Law of 6 April 1995, B.G. 3 June 1995.

19 Articles 115, §3 (BEVEK), 119, §3 (BEVAK) Financial Markets Law.

20 Royal Decree (R.D.) of 3 November 1986, B.G. 20 November 1986.

law.[21] If a Belgian company borrows a certain amount and invests that amount to acquire shares of a Belgian coordination center, the amount received by the center may not be utilized for treasury deposits. The prohibition does not apply if at least 75 per cent of the capital input is used twelve months after the contribution for other purposes than treasury deposits and during at least six months per each following year. The interest paid on the borrowed amount is tax-deductible for the Belgian parent. The interest received on the treasury deposits is exempt from withholding tax and undergoes no further corporate taxation in the hands of the center. The center could distribute the interest profit as a dividend to the parent. This dividend is tax-exempt for the parent. The final effect of the operation is a break-even of the cash streams but the tax treatment of the cost-deductible is different from the income-tax-exempt. By making huge capital contributions to a Belgian coordination center, it was possible for a Belgian parent to erode the tax basis of its other income, without any risk. The sanction of R.D. 5 August 1991 is quite extreme. If a Belgian parent and the coordination center would set up such a scheme, the license of the center will be withdrawn.

III. Thin capitalization in Belgian tax law

In order to clarify the issue of the requalification of debt as equity and its legal justification, I propose a scheme of four legal grounds on which such a requalification could be based. The first is an objective ground imposing a strict criterion about which no debate can arise. The other three are subjective grounds, depending on an interpretation, a judgment or an evaluation of a legal act and its surrounding circumstances and facts. The scope of the first subjective legal ground is rather limited, while the scope of the second ground is broader and the scope of the third one is very large:

(a) requalification based on an objective criterion: a debt to equity ratio, above which the debt is requalified as equity, is a clear example;
(b) requalification based on the characteristics of the debt itself. This kind of requalification is an identification process. The characteristics of a funding instrument, such as the definition of the remuneration, the reimbursement and the priority arrangement towards other funding sources, determine its legal nature as a debt-instrument or a capital contribution irrespective of the nature as given by the contracting parties;
(c) requalification based on external circumstances which, taking into account all the facts and the effects, demonstrate an abuse of the legal qualification as debt and justify a requalification as equity, although the characteristics of the funding instrument itself determine its nature as a debt. Thin capitalization could be such a circumstance;

[21] B.G. 7 September 1991 and confirmed by the Law of 23 October 1991, B.G. 15 November 1991. Applicable on treasury deposits from 1 September 1991 on.

(d) requalification based on a purely economic analysis of the financial position of the company, indicating the economic need of a loan or an equity funding.

Article 18, 3° ITC[22]

This article states that interest payment on advances which have been extended by the directors of capital companies and the associates[23] of private companies, their spouse or their minor children, is requalified as a dividend distribution insofar as one of the following limits is exceeded:

- the interest rate exceeds the maximum deductible interest rate of article 55 ITC or
- the total amount of the advances is higher than the paid-up capital and the taxed reserves at the beginning of the tax year.

The latter basis to requalify is a debt to equity ratio of one to one. It is widely considered as a measure against excessive profit-draining interest payments made to directors and associates of the company. It should prevent indirectly thinly capitalized companies. The requalification based on the debt to equity ratio of one to one in article 18, 3° ITC is a requalification of type (a). It is an objective criterion.

Article 18, 3° ITC was preceded by article 15, 2° ITC Old which was simultaneously restricted and extended compared to the wording of article 18, 3° ITC. The old article requalified all the interest payment on advances made by associates of private companies. There was no debt to equity ratio for the advances made by directors of capital companies, and consequently there was no requalification. The new regulations of article 18, 3° ITC are applicable on interest paid or attributed since 27 March 1992.[24]

Definition of an advance

Article 18, 3° ITC defines as an advance every loan, represented by securities or not, made by the directors or associates, their spouse or their children from whom they still have the legal benefit of the income of movable capital.[25] The definition is very broad. The designation of the loan by the directors or associates, and the source of the advances are irrelevant.

The capacity of director or associate

The requalification of interest as dividend is personally related to the mandate of director of a capital company or associate of a private company. Although the law

22 Article 1 of the Law of 28 July 1992, containing tax and financial measures, B.G. 31 July 1992 and commented by the Tax Administration in its Circular D 19/444.905 – Corporation tax, Tax and financial measures 1992, Bull. Bel., No. 732, November 1993, 3167.

23 An associate is the shareholder of a private company. He is either active (the managing director) or silent.

24 Article 47, §6 of the Law of 28 July 1992.

25 Article 384 Civil Code: "The parents enjoy the income of the movable goods of the children until they have reached the full age of 18 years or their removal of guardianship."

defines a debt to equity ratio of one to one, the identity of the shareholder of a capital company is completely irrelevant. Advances by a shareholder, not being a director, can be accumulated on an unlimited basis without any requalification, while advances by a director, not being a shareholder, are tested on the shareholding capital criterion of one to one. Also the directors with similar functions fall under the definition of article 18, 3° ITC.[26]

Associates of private companies own shares of their company. Active and silent associates are both within the scope of the measures.[27] There is a debate whether the employees with a limited number of shares and whose professional income does not qualify as income of active associates, are also implied under the rule of requalification.[28] Another question is when does the capacity of director or associate account for the requalification? The interest must relate to advances by persons who have the capacity of director or associate at the moment that the advances yield an interest return.[29] According to the Civil Code debt instruments yield interest on a day by day basis. This was confirmed by the Tax Administration in its circular. The date of making payable and the date of payment are not relevant. The concurrency between the interest-yielding character of the advance on a day by day basis and the capacity of director or associate is the criterion for article 18, 3° ITC.[30]

Safe haven rules

Article 18, 3° ITC mentions three situations in which the requalification does not take place:

(a) bonds publicly issued;[31]
(b) claims on recognized cooperative companies;
(c) advances by directors or associates who are themselves companies and subjected to the Belgian corporation tax.

Whether the legal requalification can be easily avoided by the use of an intermediary Belgian company appointed as director of the capital company or owning the shares of a private company, is unclear. The Minister of Finance has also confirmed, by way of an administrative concession, that the requalification will not apply for the deposits made by the directors or associates of a financial

26 The administrative Circular, *op. cit*., 3173; *contra* L. Plas and P. Verbanck, "Herkwalificatie van interesten in dividenden", AFT, January 1993, No. 1, 6 who plead a strict interpretation of the definition of director. Only those who are explicitly appointed as director fall under article 18, 2° ITC.

27 The administrative Circular, *op. cit*., 3173.

28 L. Plas and P. Verbanck, *op. cit.*, 6: *pro* requalification, and P. Coppens and A. Baillieux, *Droit fiscal. I. L'impôt des personnes physiques*, Brussels, Larcier, 1992, 141: *contra* requalification.

29 Supreme Court, 4 January 1973, Pas., 1973, I, 435 and Old Com. 15/14.1.

30 Article 19, §2 ITC. This analysis is similar to the definition of interest of fixed-interest bonds which is taxable for each following holder of the bond in relation to the period that he owns the bond.

31 According to R.D. of 9 January 1991 about the public character of operations to attract savings money and similar operations with a public offer.

institution.[32] The account or deposit should be subjected to the normal conditions and terms of similar accounts and deposits placed by third financial institutions.

The quantitative limits

The normal market rate

The law refers to article 55 ITC which regulates the tax-deductibility of interest as a professional expense insofar as the interest is not higher than the normal market rate, taking into consideration the special facts related to the judgment of the risk linked to the loan and especially the financial situation of the debtor and the period of the loan.[33] It is important to note that the law only requalifies the part of the interest exceeding the normal market rate. The other part, equal to the normal market rate, remains a tax-deductible interest expense.

The debt to equity ratio of one to one

The interest is requalified as dividend when the total amount of the interest-bearing advances is higher than the paid-up capital, increased by taxed reserves, as determined at the beginning of the taxable period. The non-interest-bearing advances are not considered on the condition that there is a clear distinction between the non-interest and the interest-bearing advances. If no distinction is possible, then the non-interest-bearing advances are included in the debt to equity ratio of one to one.[34]

The wording "at the beginning of the taxable period" refers only to the total amount of paid-up capital and taxed reserves. The test if the limit is exceeded in relation to the interest-bearing advances happens at each moment of the taxable period.[35] Once the amount of the interest-bearing advances is at any given moment higher than the paid-up capital and taxable reserves of which the amount is determined at the beginning of the taxable period, then the interest on the part of the advances exceeding the limit is requalified as a dividend distribution. The quantitative limitation is calculated per company and not per director or associate. If the advances have been granted by more directors and associates, a possible excess is proportionally divided. A proportional part of the interest paid to each of them will be requalified and taxed as a dividend.[36] If the total amount of reserves is negative, it is not deducted from the paid-up capital and taxed reserves at the beginning of the taxable period.[37]

32 Report for the Commission of Finance, Senate, extraordinary session 1991–92, doc. 425–2, 58 and Old Com. 15/16.

33 M.C. Sibille-Van Grieken, *op. cit.*, Belgian IFA report Toronto; the excessive interest payment above market rate is not discussed in this report.

34 *Fiskoloog*, No. 464, 24 March 1994,7.

35 The administrative Circular, *op. cit.*, 3178.

36 The administrative Circular, *op. cit.*, 3179.

37 The administrative Circular, *op. cit.*, 3177.

Requalification as an identification process: the simulation theory

Before the introduction of the so-called "economic reality" of article 344, § 1 ITC, the Belgian Tax Administration has tried several times to prove that a loan by a shareholder to its company should be identified as a capital contribution, based on the characteristics of the loan or external circumstances and facts surrounding the loan. Characteristics such as an interest-free remuneration or a profit-linked interest rate, the absence of a fixed date of reimbursement, and circumstances such as the full control by the creditor of the company, the lack of substantial guarantees and the evident insufficiency of capital to exercise the activities of the company, were cause for the Tax Administration to requalify the loan as equity according to the simulation theory.[38] Simulation supposes two agreements concluded at the same time. There is a "simulated" transaction as explained to third parties hiding the real concealed agreement to which only the contracting parties are privy.

Notwithstanding, the Supreme Court accepted only one criterion for the requalification as equity: the fact that the funding effectively undergoes the possibility of sharing the losses of the company, that the funding is subject to the negative hazards of the company's business.[39] In its judgment of 11 January 1966, the Supreme Court concluded "*... que cette somme était soumise aux aléas de l'entreprise et donc aux éventuelles pertes sociales, condition essentielle pour qu'il ait apport en société*". All other characteristics, although at first sight appearing as capital-related characteristics, and any external circumstances did not and do not justify the identification of the financial instrument as equity: the undercapitalization of the company, the subordinated character of the loan, the profit-linked or profit-sharing interest payment,[40] the fact that no interest is paid in a year that the debtor has made a loss, the absence of a fixed reimbursement date, the fact that certain authorities such as the Belgian Banking Commission consider the loan as equity for reasons of solvency, etc.

The requalification of the type (b) (requalification based on the characteristics of the debt itself), such as the legal theory of simulation, is only accepted by the Belgian Supreme Court insofar as the funding effectively shares the potential losses of the company's business. In reality, it is nearly impossible to provide this kind of evidence.[41]

This widely accepted opinion of the Supreme Court should be distinguished from the Belgian Court decisions which try to counteract the money-laundering system of foreign letter-box companies extending loans to Belgian companies. The latter ones have delivered various judgments: the non-deductibility of the interest payment, the requalification as secret compensation and also the requalification as dividend. Nevertheless these last judgments, requalifying interest as dividend,

38 S. Van Crombrugge, *Juridische en fiscale éénheidsbehandeling van vennootschapsgroepen*, Kluwer, Antwerp, 471 with reference to several judgments of the courts.

39 Supreme Court, 5 September 1961, Pas. 1962, I, 29 and 11 January 1966, Pas. 1966, p. 611 and 15 April 1969, Pas. 1969,I, p. 721.

40 Old Comments Tax Administration 13/3 a considers the profit-sharing interest as an interest.

41 S. Van Crombrugge, *op. cit.*, Kluwer, Antwerp, 472.

have been criticized on the basis that in order to requalify they should be grounded either on the simulation theory of the Supreme Court, as mentioned above, or on the theory of "economic reality" of article 344, 1 ITC.[42]

Article 344,1 ITC: requalification according to a purpose test[43]

In the past Belgium occupied a rather unique position in the field of tax-avoidance due to the absence of any anti-avoidance provision in the Income Tax Code. The Courts took the view that a transaction, however economically abnormal, could not be set aside by the Tax Administration on the ground that it was solely entered into to avoid taxes as long as all legal consequences were fully accepted by the parties to the transaction. It is interesting to note that the famous *Brepols* case which was introduced by the Courts, dealt with a thinly capitalized subsidiary. The facts of the case were as follows. An industrial company converted itself into a financial holding company by assigning its trade activities to a newly incorporated subsidiary. It then granted a very large loan to the thinly capitalized subsidiary with the result that all the profits of the subsidiary were reduced by the interest payable to the parent company in respect of the loan. The Brussels Court of Appeal[44] upheld the decision of the Tax Administration which had requalified the loan for tax purposes as a capital contribution giving rise to payments of non-deductible dividends by the subsidiary to the parent.

The Belgian Supreme Court reversed the decision of the Court of Appeal. It affirmed that a transaction is fully acceptable for tax purposes "when the parties with a view to putting themselves in a more favourable tax position, make use of their right to freely arrange their affairs by entering into contractual agreements of which they accept all the legal consequences and which do not violate the law, even if the route thus chosen is not the most normal one".[45] The *Brepols* doctrine of the Supreme Court as adhered to strictly by the Belgian Courts, did not enable the Tax Administration to counteract thinly capitalized companies by requalifying the excessive loans as capital contributions.

The law of 22 July 1993 with retroactive effect to 31 March 1993[46] introduced the so-called "economic reality" in the amended article 344, §1 ITC: "The legal qualification given by the parties to a specific deed or to separate deeds which realize the same operation can not be opposed to the Tax Administration when the

42 Antwerp, 28 June 1994, AFT, 1995, No. 1, 28 with note of G. Jorion.

43 M. Dassesse, "Introduction of the economic reality test in Belgian tax law: years of uncertainty ahead?", *Bulletin IFA*, March 1994, 127; C. Vanderkerken, "New Anti-avoidance Legislation", *European Taxation*, January 1994, 25; S. Van Crombrugge, "De invoering van het leerstuk van de fraus legis of wetsontduiking in het Belgisch fiscaal recht", TRV, 1993, No. 16, 281; J. Malherbe, Th. Afschrift, A. De Roeck, A. Rombouts and A. Lawton, 'Requalification of transactions for tax purposes under section 344, § 1 of the Belgian Income Tax Code – Potential application to coordination centers", *Interfax 1994*, 8–9, 381.

44 Court of Appeal of Brussels, 25 March I959,R.F., 1960,213.

45 Supreme Court, 6 June 1961, Pas., 1961, I, 1082.

46 B.G. 26 July 1993: articles 16 and 23, §4.

Administration determines, by presumptions or any other acceptable piece of evidence, that this legal qualification aims at avoiding taxes, unless the taxpayer provides evidence that this qualification is justified by legitimate motives of a financial or economic nature."

Article 344, §1 ITC is applicable to a structure insofar as the Tax Administration provides evidence that the deed has been motivated to set up a tax-avoidance structure. The Tax Administration should examine the effects of a transaction and the factual circumstances surrounding the transaction.[47] These effects and circumstances are the essential elements from which the purpose of tax avoidance can be concluded. The taxation of the transaction would then be levied pursuant to the "normal characterization" of the transaction. If the transaction comprises a single deed, the tax authorities may choose the requalification which generates the highest taxation provided they prove that the legal qualification chosen by the parties has no other motives than tax avoidance. If the transaction is made up of two or several deeds, tax may be levied giving the transaction one requalification without taking into account the ones given by the parties to each of the different deeds, provided that the Tax Administration proves that these deeds are actually one single transaction and that the artificial dissembling by different deeds is only tax motivated (step-by-step approach in order to reassemble the artificial cut-outs). The Tax Administration can only modify the legal qualification and not the transaction itself. A new qualification must be given to the deed or the deeds concerned[48]and the real legal characteristics of the transaction may not be affected.

A crucial question is which circumstances or facts could induce the tax authorities to requali fy a debt as equity under the theory of "economic reality". A lot of authors arc convinced that only certain characteristics of the loan itself, which are rather capital-related, could reveal a tax avoidance purpose and lead to a requalification.[49] They refer to facts such as an interest-free remuneration, a profit-participating interest, the subordination of the loan, no fixed date of reimbursement, or a combination of those elements unless a taxpayer is able to justify a financial or economic motive for those elements. For banks, the loans which may be accounted to calculate the risk capital ratio (Upper and Lower Tier II) under the existing banking regulations, cannot be requalified as capital due to the subordinated character of these loans because the subordination is financially justified (to increase the capital risk ratio) and not solely tax motivated.

Since a requalification according to the "economic reality" is not allowed to affect the legal characteristics of a transaction, a requalification of a *pure* loan (i.e. without the above-mentioned capital-related elements) is not possible. Essentially, this opinion adheres to an identification process of loan or equity, even under the application of the "economic reality" theory. It is a requalification of the type (b) (requalification based on the characteristics of the debt itself)· This

47 Document Senate, 1992–1993, 762–2, 37.
48 Document Parlement 1072/8–92/93, 100.
49 J. Kirckpatrick, "La requalification fiscale des opérations accomplies abusivement dans le seul but d'éviter d'impôt sous l'empire du nouvel article 344, §1 C.I.R.92.", C.J., No. 1, 1994, 4; J. Malherbe *et al*., *op. cit*., 397.

interpretation extends the simulation theory of the Supreme Court by allowing a requalification based on characteristics of the loan other than the possibility of sharing the losses of the company's business, because those other characteristics, since they are capital-related, could reveal a purpose of tax avoidance.[50] The "economic reality" theory facilitates for the Tax Administration the burden of proof which was very heavily and strictly determined by the Belgian Supreme Court in the simulation theory.

It is the wording of the law that the legal qualification of a transaction, if solely tax *motivated*, cannot be opposed to the Tax Administration who must provide another legal qualification. Article 344, §1 ITC is not only a test of "to be or not to be" but also a purpose test, i.e. "what is the justification of an operation?" The law does not exclude external circumstances and facts revealing a purpose of sole tax avoidance. An example of such an external fact, is precisely an abnormal low level of capitalization. The taxpayer is obliged to give a financial or economic motive for funding the company by a loan and not by the subscription of additional capital.[51] The relevance of such an external circumstance or fact is that maybe one capital-related element of a loan would not be sufficient in order to demonstrate the solely tax-motivated funding, but that an external circumstance, such as thin capitalization, *in addition* could be helpful for the Tax Administration to evidence the solely tax motivation of the funding. Because a requalification is not permitted to affect the real legal characteristics of a transaction, there always must be a capital-related characteristic of the loan itself in order to requalify. A pure loan, bearing all the normal legal characteristics of a debt instrument, cannot be requalified due to the sole external fact of thin capitalization. A requalification of the type (c) (requalification based on external circumstances) is possible only insofar that a combination is made with the requalification of the type (b) (requalification based on the characteristics of the debt itself).

If the tax authorities consider a legal qualification as a purely tax-avoidance motivated qualification, taxpayers can prevent the requalification if they can evidence that the qualification as chosen by them is justified by financial or economic purposes. It is the legal qualification itself and not the underlying operation which should be considered. For qualifications having both financial or economic and tax-avoidance purposes, the "economic reality" cannot be applied. One financial or economic motive for the legal qualification of a loan prevents a thin capitalization requalification. Article 344, §1 ITC is a "*sole* purpose test". The foregoing implies that a principle of taxation according to the *best* economic options for a company, is not possible.[52]

This conclusion affirms the well-known and generally accepted principle that the Tax Administration is not authorized to question the opportunism of the management options. If taxpayers can choose between loan or capital as a way of

50 D. Merckx, *De economische werkelijkheid*, CED-Samsom, 69: the subordinated character of the loan as capital-related fact.

51 S. Van Crombrugge, *op. cit.*, TRV, 1993, 283.

52 Document Senate, 1992-1993, 762-2, 37: "*il n' introduit pas l'imposition suivant la réalité économique*"; S. Van Crombrugge, *op. cit.*, TRV, 1993, 283; C. Vanderkerken, *op. cit.*, 24.

providing funds to a company and each could be justified by a reasonable economic or financial reason, the Tax Administration may not impose the legal qualification of equity because it is widely considered as the best economic choice.

A requalification according to type (d) (requalification based on an economic analysis) is not possible under Belgian legislation.

At present, two different types of anti-avoidance rules exist in Belgian tax law. One general anti-avoidance provision, i.e. "the economic reality" of article 344, §1 ITC and several specific ones. Article 18, 3° ITC is a specific anti-avoidance provision.

The question arises whether both types are to be applied together or whether application of a specific anti-avoidance rule excludes the application of the general provision. After the introduction of article 344, §1 ITC, new specific anti-avoidance provisions were introduced.[53] This fact demonstrates that a specific provision has priority above a general provision for transactions covered by specific anti-avoidance rules.[54] Application of a specific provision, precisely by its nature, excludes the application of the general provision. Administrative comments or the Courts have not yet confirmed this principle.

In relation to thinly capitalized companies, one can argue that the provision of "economic reality" does not apply if all the conditions of article 18, 3° BITC are fulfilled. Loans extended by directors to their corporation (*naamloze vennootschap*) which do not exceed the capital ratio of one to one and which bear a normal market interest rate, cannot be requalified as capital contributions according to the theory of "economic reality". Nevertheless a requalification, based on the simulation theory, remains possible if the tax authorities prove that the loans are effectively sharing the losses of the company's business.

If a taxpayer wishes to ascertain in advance that a proposed legal qualification will not be requalified according to the "economic reality" theory, he may request a ruling.[55] If a ruling is favorable, the qualification of the transaction, as proposed by the taxpayer and accepted in all its legal consequences, may not be set aside by the Tax Administration on the ground that the qualification would be purely tax-driven.

Article 26 ITC: transfer pricing

In the Belgian tax legislation, transfer pricing is being dealt with in article 26 ITC. With the reservation of article 54 ITC, abnormal or benevolent advantages granted by a Belgian enterprise, are added to the taxable profits of the enterprise, insofar as these advantages are not used to determine the taxable income of a Belgian taxpayer. In addition, the law specifically states that these advantages must be included in the taxable profits of the Belgian enterprise when the advantages are

53 Just one recent example: the Law of 4 April 1995, B.G. 23 May 1995, about the prohibition of the use of any carry-forwards for dormant companies.

54 C. Vanderkerken, *op. cit.*, 25.

55 Article 345, §1 ITC.

given directly or indirectly to a foreign associated taxpayer, or to a foreign taxpayer who is not subjected to an income taxation or subjected to a substantially more favorable tax regime than in Belgium. An advantage is abnormal if it deviates from the normal rules and customs. An advantage is benevolent if it is performed without any obligation or real transaction in return.

In relation to financial instruments, article 26 ITC has frequently been used to counteract borrowings with an interest rate too high or loans with an interest rate too low or loans without any interest payment. In the first situation, the Belgian enterprise paid too much interest according to an arm's length criterion and in the second situation, the Belgian enterprise received too little interest or no interest at all according to an arm's length analysis. Also the cancellation of claims by a Belgian company in favor of its foreign subsidiary has been tested on article 26 ITC and could sometimes be regarded as benevolent.[56] It is generally agreed that a requalification of loan as equity cannot be based on article 26 ITC. Article 26 ITC is only able to add back a certain amount to the taxable profits of a Belgian enterprise due to the abnormal or benevolent character of an advantage. Surprisingly, thin capitalization has not been an issue in the area of Belgian tax regulations of transfer pricing.

IV. Application of double tax treaties – international aspects

In 1987, the OECD published a report about thin capitalization.[57] The new comments of the OECD Model Tax Treaty 1992 also discussed thin capitalization under the articles 9, 10 and 11.[58]

Article 9 of the OECD Model Tax Treaty – arm's length principle

According to article 9(1) it is possible to adjust the taxable profits between associated companies where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. The question is whether article 9(1) permits a requalification of loan as capital under the Belgian tax legislation. The question relates especially to the disallowance of the interest paid due to its requalification as non-deductible dividend. The issue of the rate of withholding

56 S. Van Crombrugge, "Het arm's length-criterium bij multinationale groepen in het Belgisch fiscaal recht", TRV 1988, 84 and for a complete review: J. Thilmany, *Winstoverdrachten*, CED-Samsom, No. 94/19, 88–94.

57 *Thin capitalisation*, Issues on International Taxation, No. 2, Paris, OECD, 1987.

58 B. Peeters and H. Vanoorbeek, "OESO-Modelverdrag 1992 & Commentaar: een ondernemingsgerichte analyse", Studiecentrum voor fiscaal en financieel recht, Belgisch-Luxemburgse afdeling van de International Fiscal Association, 16 June 1994, 25 and Fiduciaire Berichten, August 1994.

tax, depending on the qualification as interest or as dividend, is being dealt with under the articles 10 and 11.

The OECD Committee generally agreed that, in principle, the thin capitalization rules of any internal legislation must be tested on the arm's length principle of article 9(1). Because in Belgium a double tax treaty has precedence over the internal legislation,[59] a requalification of loan as capital will only be possible insofar as the requalification does not violate the arm's length principle.

The specific question is whether the loan, as being granted by or to a foreign associated company, established in a country with a double tax treaty with Belgium, would have been granted between independent parties. In other words, would a third party, especially a non-associated bank, have given the loan under the same conditions and terms? If the answer on this question is negative, then a double tax treaty does not prevent the Belgian Tax Administration to requalify according to article 18, 3° ITC and the theory of "economic reality" (a requalification, based on the simulation theory, which is rather an identification process, should be verified under the articles 10 and 11 of the OECD Model Tax Treaty). To compare with the conditions and terms of a loan between independent parties is extremely difficult in the area of thin capitalization because, per definition, someone who subscribes shares, is not a third party. The moment one does acquire shares, one becomes a shareholder and an associated enterprise. It is also normal that a parent shareholder company has more and secret information about its subsidiary, possibly justifying a loan financing.[60] A parent company while financing its subsidiary has other motives than a third party. A parent company is willing to take certain risks, is concerned about the general fame of the group while a third party only wants a safe investment, earning a sufficient interest return. Taking into account the group motives, a parent company will probably demand fewer guarantees than a third party. An arm's length analysis testing the articles 18, 3° ITC and 344, §1 ITC on which a requalification is based, should take into account these other motives.[61]

In the new OECD report about transfer pricing, the Tax Administration must accept the real executed operations of the taxpayers, except if the form of an operation differs from its economic contents. The tax authorities are then permitted to requalify according to the real economic nature of the operation, while making an arm's length analysis.[62] This kind of requalification of loan as capital based on a purely economic analysis (a requalification of type (d)) is not possible in the Belgian tax legislation.

59 Comments Administration Treaties 0/14.

60 B. Peeters, *op. cit.*, TRV, 107.

61 S. Van Crombrugge, *op. cit.*, TRV, 1988, 75 where the author argues for a balance between a strict "independent parties analysis" and the sound economic and financial group motives.

62 H. Symoens, "Het nieuwe OESO-rapport inzake transfer pricing", *Fiskoloog Internationaal*, No. 137, 15 April 1995, 1. The author gives only one example: a loan could be requalified as a capital contribution if between non-associated companies the loan would never have been granted due to the economic circumstances of the debtor. As explained, the rules of transfer pricing in Belgian tax legislation do not permit such a requalification.

Requalification according to Belgian law

The interest payment is Belgian source

Foreign companies without a Belgian permanent establishment are not subjected to Belgian corporation tax. The safe haven rule of article 18, 3° ITC is not applicable. If a foreign director gives a loan to its Belgian company, exceeding the debt to equity ratio of one to one, then the requalification of interest paid as a non-deductible dividend distribution according to article 18, 3° ITC is only valid insofar as the loan financing is not at arm's length. If on the contrary the terms and conditions of the loan are absolutely normal (i.e. a third party would have given the loan under these same conditions and terms), the disallowance of the interest paid is contrary to article 9(1) of the double tax treaty between Belgium and the country of residence of the director. The interest is tax-deductible regardless of the extent to which the amount of the loan exceeds the capital and reserves.[63]

If a foreign shareholder gives a loan to its Belgian subsidiary and the Tax Administration requalifies the loan as capital according to article 344, §1 ITC due *inter alia* to the fact that the Belgian company is extremely undercapitalized, the disallowance of the interest paid is correct insofar as the loan would not have been given by a third party and insofar as the Belgian company is not able to give a financial or economic reason for the legal qualification of a loan. In other words, the Belgian subsidiary with a parent company established in a country with a double tax treaty with Belgium, has a second weapon to defend itself against article 344, §1 ITC: the arm's length analysis.

Furthermore, the non-discrimination clause of article 24, §4 and/or 24, §5 of the Treaty could prevent requalification of loan as capital and consequently the non-deductibility of the interest payment. But, since the OECD concluded that the non-discrimination clause could be appealed if the requalification violates the arm's length analysis and could not be appealed if the arm's length test is satisfied, there is little additional value in elaborating the point of the non-discrimination clause.

If the foreign director or shareholder is a private individual, the disallowance of the interest due to the requalification according to article 18, 3° ITC and article 344, §1 ITC cannot be put aside based on an arm's length analysis. A private individual does not fulfill the definition of enterprise of article 9(1) of the Treaty. He cannot claim the benefit of article 9(1).

Belgian permanent establishments of foreign companies are not subjected to the Belgian corporation tax, but to the Belgian non-resident tax for corporations. The safe haven rule of article 18, 3° ITC is not applicable. The requalification applies to an advance, which is part of the assets of a Belgian permanent establishment of a foreign company. The interest which is paid by a Belgian company to its director or associate (being a foreign company but the advance is an asset of its Belgian

63 B. Peeters, "Herkwalificatie interesten betaald aan bestuurders: grote problemen op internationaal vlak", *Fiskoloog Internationaal*, No. 102, 15 May 1992, 2.

permanent establishment) is a non tax-deductible expense under the conditions of article 18, 3° ITC.

The Belgian permanent establishment receiving the requalified interest, can claim the dividend exemption system.[64] If the Belgian tax authorities would refuse the dividend exemption on the requalified interest as dividend, the permanent establishment can also argue that article 18, 3° ITC is not applicable at all because it is contrary to the non-discrimination clause of the double tax treaty between Belgium and the country of the foreign company.[65]

Belgian directors of foreign companies

Article 18, 3° ITC is not applicable when a Belgian company, being director or associate of a foreign company, extends a loan to that company exceeding the debt to equity ratio of one to one. Advances by companies, subject to the Belgian corporation tax, fall under the safe haven rules. A Belgian permanent establishment of a foreign company A gives advances to another foreign company B, and the company A is director of the company B while the advances are booked as an asset of the Belgian permanent establishment of A. The establishment can claim the requalification of the interest as dividend and consequently the tax exemption in relation to the requalified interest. Since the foreign company B, paying the interest, normally will obtain the tax deductibility of the paid interest, an international double tax deduction is created.[66]

Requalification according to foreign law

Suppose foreign tax legislation imposing thin capitalization rules on a subsidiary of a Belgian parent company requalifies the loan given by the Belgian parent to the foreign subsidiary as a capital contribution. The interest paid by the foreign subsidiary is disallowed and the requalification meets the arm's length principle of article 9(1) of the relevant double tax treaty.

Will the Belgian Tax Administration be willing to make a similar adjustment and to recognize interest received as non-taxable received dividend, insofar as the conditions of the dividend-exemption method are fulfilled? Based on the new OECD comments of 1992, Belgium should be obliged to grant the dividend exemption on the received requalified interest as dividend.[67] Nevertheless, because Belgium has decided not to adopt article 9(2) of the OECD Model Tax Treaty in its double tax treaties, one may fear that the Belgian Tax Administration will not accept the requalification of taxable interest as non-taxable dividend. The EC

64 Article 202, 1° ITC: dividend-exemption since the law simply mentions dividends and does not exclude requalified interests. *Fiskoloog*, No. 391, 20 August 1992, 2.

65 J. Malherbe, "Intérêts d'avances et loyers perçus par les administrateurs ou associés depuis la loi du 28 juillet 1992", JDF, 1993, 1/2, 9.

66 *Fiskoloog*, No. 391, 20 August 1992, 2.

67 The new OECD comments No. 67 and 68; B. Peeters and H. Vanoorbeek, *op. cit.*, *Fid. Berichten*, 170.

Convention on Arbitration for elimination of double taxation[68] could be more helpful in order to enforce a satisfying solution for the parent and subsidiary. The EC Convention is applicable from 1 January 1995.

Article 10 (dividend) and article 11 (interest)

The question is whether the definitions of the articles 10 and 11 of the OECD Model Treaty are applicable in a situation of requalification of loan as capital. Does the requalification also lead to the characterization of interest as dividend for the purposes of the correct rate of withholding tax ? At first sight, the answer would be an easy one because the definition of a dividend in article 10, §3 of the Treaty contains the wording "income from other corporate rights which is subjected to the same taxation treatment as income from shares". Nevertheless, in the same definition it is clearly stated that a dividend is an income from rights, not being debt claims. The conclusion of the OECD Committee was that the articles 10 and 11 do not prevent the treatment of interest as dividend under national rules dealing with thin capitalization where the contributor of the loan effectively shared the risks of the company's business.[69]

The fact that the contributor of the loan does share the risks of the borrowing company's business, should be established by reference to all the relevant circumstances. Provided as an example of such circumstances, are the facts that the loan very heavily outweighs the contributions of capital to the debtor company (debt-to-equity ratio) or replaces a substantial proportion of capital which has been lost; participation by the creditor in the profits; the repayment of the loan is subordinated to the claims of other creditors; no fixed provisions for repayment of the loan by a definite date; the interest rate depends on the volume of the available profits. The OECD report also adds that interest on participating bonds or interest on convertible bonds until such time as the bonds were actually converted into shares, should not be regarded as dividends.[70]

Logically, a requalification of interest as dividend is allowed under the articles 10 and 11 of the double tax treaties under the same conditions as the requalification which is based on the Belgian simulation theory (a requalification of the type (b)). The articles 10 and 11 define the nature of the interest and dividend; this is similar to the identification process under the Belgian simulation theory. Also the interpretation of article 344, §1 ITC – remaining an identification process but accepting more circumstances or facts which could evidence that the

68 L. Hinnekens, "Het EEG-verdrag betreffende fiscale arbitrage", AFT, No. 11, November 1991, 301; B. Peeters, "E.E.G.-Verdrag ter afschaffing van dubbele belasting in geval van winstcorrecties tussen verbonden ondernemingen", *Fiskoloog Internationaal*, 15 December 1990, 2; R. Nietvelt, "Winstcorrecties: Europees Arbitrageverdrag in werking", *Fiskoloog*, No. 523, 14 June 1995, 1.

69 OECD *Report on Thin Capitalisation*, 1987, 24.

70 OECD *Report on Thin Capitalisation*, 1987, 25.

financial instrument is subject to the hazards of the enterprise's business – is not contrary to the articles 10 and 11 of the Treaty.

A requalification of loan as equity which is solely based on a debt to equity ratio (type (a) requalification as article 18, 3° ITC), while the characteristics of the financial instrument indicate a real loan, is contrary to articles 10 and 11 of the double tax treaties. A requalification of the type (a) has no impact on the rates of withholding tax as originally deducted from the gross amount of the dividend and interest according to their contractual legal nature between parties.

So it is perfectly possible that a loan is requalified as capital according to article 18, 3° ITC in an international situation and that the interest payment qualifies as non-deductible dividend because the situation does not meet the arm's length analysis, although the rate of withholding tax is determined based on the rate applicable for interest.

Requalification according to Belgian law

The interest payment is Belgian source

Specifically for the application of article 18, 3° ITC, there is in the major part of the Belgian double tax treaties few discussions whether the requalification is contrary to the definitions in articles 10 and 11. Those treaties state explicitly in article 10 that the term dividends shall include the income – even when paid as interest – from capital invested by partners (associates) or participants of companies other than companies limited by shares who are residents of Belgium.[71] This treaty definition does not apply for interest payment by a Belgian capital company to its director.[72] So only for interest payment by a Belgian private company to its associate, the rate of withholding tax for dividends is applicable. If the foreign associate is a company benefiting from the advantages of the Parent-Subsidiary EC Directive, it is unclear whether that part of the loan, being requalified as capital, can be taken into account to calculate the 25 per cent minimum participation.[73] For the application of the double tax treaties, the new OECD comments clearly state that a loan, being requalified as capital, must be taken into account to determine the 25 per cent participation level such as mentioned in article 10 of a majority of double tax treaties.[74]

The interest payment is foreign source

Article 18, 3° ITC is also applicable to foreign companies. Assuming that a private Belgian individual (director or associate) gives a loan exceeding the debt to equity

71 See e.g. treaty with Germany, article 10(5), 1; with the Netherlands, Protocol article V; with the United Kingdom, article 10(4).
72 B. Peeters, *op. cit.*, *Fiskoloog Internationaal*, No. 102, 15 May 1992, 1.
73 B. Peeters, *op. cit.*, *Fisk. Int.*, No. 102, 4; see article 106, §5 R.D. exc. ITC.
74 B. Peeters and H. Vanoorbeek, *op. cit.*, *Fid. Berichten*, 156.

ratio of one to one, he will be obliged to pay the Belgian withholding tax related to dividends on the requalified interest payment.

Requalification according to foreign law

Suppose foreign tax legislation, imposing thin capitalization rules on a subsidiary of a Belgian shareholder, requalifies the loan given by the Belgian shareholder to the subsidiary as a capital contribution. Since the Belgian withholding tax on interest is normally lower than the withholding tax on dividend and the Belgian withholding tax is the final taxation for a private individual, it is in his best interest to declare an interest payment in his tax return and not to put forward the requalification. The same conclusion is applicable for a Belgian company if a foreign withholding tax is deducted. As mentioned before, one can fear that the Belgian Tax Administration will not grant the dividend exemption on the requalified interest payment. They remain taxable. But for foreign source interest it is possible to claim a foreign withholding tax credit, contrary to a foreign dividend where no foreign withholding tax credit is available.[75]

V. Fat capitalization

Due to the high rate of corporation tax of 40.17 per cent, it is for a Belgian company tax-wise more interesting to increase substantially the capital of a foreign subsidiary ("fat capitalization"), established in a country with a lower tax rate, if the received dividends qualify for the dividend exemption according to article 202 ITC. Although article 203 ITC demands that the foreign company is subjected to a tax similar to the Belgian corporation tax and rules have been introduced to prevent the use of intermediary holding companies, it is still possible to benefit from the dividend exemption on foreign dividends distributed by a company established in a country with a very low corporation tax rate due to a double tax treaty with Belgium in which an equal treatment clause is incorporated.[76]

The consequence of a requalification of capital as loan is that the Belgian company would not receive a tax-free dividend but a taxable interest payment. A different rate of Belgian withholding tax, either on dividends, or on interest payments, is not relevant because a Belgian company can obtain an exemption of Belgian withholding tax on foreign dividends and interest.[77]

Simulation theory

As in the case of thin capitalization, the tax authorities could apply the simulation theory to requalify the capital as loan to the extent it is shown that the capital does

75 Article 287 ITC.

76 B. Peeters, "Uitvoering Moeder-dochter Richtlijn: aanpassing van de eigenlijke DBI-aftrek", *Fiskoloog Internationaal*, No. 95, 15 October 1991, 4.

77 R.D. exc. ITC, articles 106, §1 and 108.

not share the risks of possible losses of the subsidiary's business. An example of a fact demonstrating non-participation in the hazards of the company, is a fixed day of redemption combined with a third party guarantee in relation to the redemption of capital.

The theory of "economic reality" of article 344, §1 ITC

A capital contribution, as a singular transaction

Contrary to thin capitalization, a requalification according to the theory of "economic reality" on "fat capitalization" should be applied on a more restricted basis. It seems quite paradoxical that tax authorities would requalify capital as loan because from an economic point of view, capital contributions are far better than loans. Capital strengthens the solvency of the company and the credit standing as third creditors obtain a bigger guarantee of repayment in case of a default of the company. A capital contribution itself is economically justified due to its nature, so that the taxpayer can give automatically the evidence of a financial or economic motive. Furthermore it is a general accepted principle in Belgium that tax authorities should not meddle in the opportunity choices made by a company. To opt for a capital increase of a subsidiary is essentially a strategic decision,[78] with far reaching consequences for investments, employment, marketing possibilities, etc. Based on these reasons, a requalification of capital as loan is only possible as type (b) in the limited meaning that evidence should be given of one characteristic, i.e. that the capital does not share the company's risks.

Nevertheless, the Belgian Ruling Committee of the Tax Administration refused to give a ruling on the question whether capital contributions to an Irish IFSC company were economically or financially justified. The Ruling Committee said that the transaction was principally based on tax reasons and aimed to convert taxable interest as tax-free dividend according to the dividend exemption rule.[79] The Ruling Committee said nothing about the fact of an excessive capitalization. Nor was an interpretation of the relation between article 344, § l ITC and the Belgian–Irish double tax treaty on "fat capitalization", mentioned.

A capital contribution, as part of different transactions

Requalification of capital as loan based on the theory of "economic reality" is rather unclear when a scheme of different transactions probably lack any financial or economic justification precisely due to the nature of the scheme. The least complicated scheme consists of a Belgian parent company making capital contributions to a lower taxed foreign company which immediately lends those funds back

78 B. Peeters, *op. cit.*, TRV 1989, 109.

79 J. Van Dyck, "Rulingcommissie weigert antwoord voorafgaand schriftelijk akkoord over gebruik van Ierse IFSC's", *Fiskoloog*, No. 488, 6 October 1994, 1.

to the parent which claims simultaneously the tax deductibility on the interest payment and the dividend exemption on the received dividend.

Because such a scheme is purely tax motivated, one can fear that the Tax Administration could try to apply the theory of "economic reality" and requalify the capital as loan.[80] All circular transactions from which the first step is a capital contribution, creating tax-free dividends, are probably suspect for the tax authorities. In an international situation (the subsidiary of the Belgian parent company is established in a country with a double tax treaty with Belgium) the requalification of capital as loan would only be possible insofar that the test of an arm's length analysis is not fulfilled.

Article 344, §2 ITC

The Belgian tax authorities have another article at their disposal to counteract the capital contributions to lowly taxed companies. Article 344, §2 ITC states that the transfer of cash or assets to a holding company based abroad and benefiting from a special tax regime cannot be opposed to the Tax Administration unless the taxpayer can prove that the transaction meets certain economic or financial legitimate needs, or that a taxable income was generated in Belgium from this transaction. This article does not requalify. If applicable, the capital contribution simply does not exist for the tax authorities who would consider the situation prior to the capital contribution.

VI. Evaluation

A requalification of loan as capital is possible according to the Belgian legislation, specifically based on article 18, 3° ITC, the simulation theory and the "economic reality" of article 344, §1 ITC. Article 18, 3° ITC contains a thin capitalization ratio of one (capital) to one (advances of a director or associate). Peculiarly, this requalification is for capital companies not linked with the advances by a shareholder, but by a director of the company. It is not possible to react against the pure fact of thin capitalization, according to the simulation theory. The criterion of sharing the company's risks, which determines the character of capital in order to requalify, is very strict. The theory of "economic reality" can only be used against the fact of thin capitalization when a requalification does not affect the legal characteristics. This requalification assumes that the excessive debt has certain capital-related elements. Taking into account the double tax treaties, a requalification of loan as capital based on article 18, 3° ITC and the theory of "economic reality" is only possible if the at arm's length citerion is not respected.

[80] *Contra* J. Malherbe *et al*., *op. cit*., 399 giving the example of a Belgian parent company and a coordination center as a subsidiary. He states that the requalification of capital as loan (with no debt-related characteristics) is not possible even in the above-mentioned scheme because the tax requalification cannot affect the legal characteristics of a transaction.

Contrarily, if the loan meets all the market conditions, then a requalification is not possible and the interest payment remains tax-deductible. For the determination of the correct rate of withholding tax, the test of sharing the company's risks approximates very closely the simulation theory. If this test is not fulfilled, the rate of withholding tax for interest remains applicable.

A requalification of capital as loan due to "fat capitalization" could only be possible according to the theory of "economic reality" if the capital contribution is part of a scheme of several transactions evidencing a solely tax motivation and certain debt-related characteristics. Of course, this requalification is in international situations only possible if the arm's length analysis is violated.

Résume

Le rapport a trait non seulement aux aspects fiscaux de la sous-capitalisation des sociétés, mais également au sujet plus vaste du reclassement du prêt en capital. Dans l'introduction, le rapport étudie brièvement le traitement fiscal des dividendes et des intérêts, les aspects non fiscaux corrélés d'un niveau de capital minimum et une définition de la „surcapitalisation". Le décret royal 187 du 5 août 1991 vise à empêcher la capitalisation excessive des centres de coordination belges motivée par l'impôt.

La législation fiscale belge reclasse le paiement des intérêts sur les avances qui ont été consenties par les directeurs des sociétés de capitaux et les associés de sociétés privées en distribution de dividendes dans la mesure où le montant total des avances est plus élevé que le capital entièrement versé et les réserves imposées au début de l'année (article 18, 3° du Code des impôts). Sur la base de la théorie de la simulation, un reclassement du capital emprunté en capital propre n'est possible que si le capital emprunté est soumis aux risques inhérents aux activités de la société. Les dispositions de l'article 344, paragraphe 1, du Code des impôts visant à lutter contre l'évasion, applicables aux titres depuis le 31 mars 1993, sont relativement floues. 11 semble qu'un reclassement de capital emprunté en capital propre, dû à des actes effectués à des fins fiscales tels que la souscapitalisation de la société, n'est valide que si le capital emprunté comporte certaines caractéristiques liées au capital propre. Une mesure de reclassement spécifique telle que l'article 18, 3°, du Code des impôts l'emporte sur la disposition générale de l'article 344, paragraphe 1, du dit Code. Un reclassement fondé sur une analyse économique n'est pas autorisé.

Par ailleurs, il est généralement admis qu'un reclassement ne peut être fondé sur la législation fiscale belge traitant du prix de transfert.

Compte tenu des aspects internationaux, l'OCDE a conclu qu'un reclassement ne peut être contraire à une analyse de l'entreprise indépendante figurant à l'article 9 des conventions de double imposition. Une personne physique ne bénéficie pas de cette dernière protection. Les intérêts servis par une société belge à son directeur ou associé (s'agissant d'une société étrangère, seule l'avance est un actif de son établissement stable belge) pourraient être reclassés comme un dividende non déductible, mais l'établissement stable belge peut demander l'exemption du dividende. Lorsque la législation fiscale étrangère impose des règles sur la sous-capitalisation, la société-mère belge peut également soutenir que les intérêts reclassés doivent favoriser l'exemption du dividende. On peut craindre que l'administration fiscale belge ne soit pas d'accord, de sorte que la Convention des CE sur l'arbitrage pour l'élimina-

tion de la double imposition devrait fournir une solution. Un reclassement des intérêts comme dividendes, en relation avec le problème de l'impôt anticipé, n'est autorisé que dans les mêmes conditions que le reclassement aux termes de la théorie belge de la simulation: partage des risques inhérents aux activités de la société emprunteuse. Nombre des conventions de double imposition conclues par la Belgique contiennent une définition élargie du dividende. Les intérêts reclassés sur des avances consenties par des associés de sociétés privées conformément aux dispositions de l'article 18, 3°, du Code des impôts, sont soumis à l'impôt anticipé applicable aux dividendes. Le terme de „surcapitalisation" fait référence à un apport de capitaux excessif d'une société étrangère bénéficiant d'un régime fiscal privilégié, tandis que les dividendes distribués donnent droit à l'exemption des dividendes dans le chef de la société-mère belge. La théorie de la simulation permet le reclassement en tant que capital emprunté lorsque les apports en capital ne partagent pas les risques inhérents aux activités de la filiale. Un reclassement du capital propre en tant que capital emprunté, conformément aux dispositions de l'article 344, paragraphe 1, du Code des impôts, en tant qu'opération isolée, n'est pas possible. On ne voit pas très bien si un apport en capital, en tant que partie de différentes opérations, pourrait être reclassé comme capital emprunté dans la mesure où le régime a pour but de lutter contre l'évasion fiscale et où le capital emprunté présente des caractéristiques liées aux dettes.

Zusammenfassung

Der Bericht bezieht sich nicht nur auf die steuerlichen Aspekte der Unterkapitalisierung handelsrechtlicher Gesellschaften, sondern erörtert auch das breitere Thema der Umqualifizierung von Darlehen zu Kapital. Die Einführung des Berichtes erörtert kurz die steuerliche Behandlung von Dividenden und Zinsen, die nicht steuerbezogenen Aspekte der Mindestkapitalausstattung und den Begriff der „Überkapitalisierung". Der Königliche Erlass 187 vom 5. August 1991 bezweckt die Verhinderung einer steuerlich motivierten Überkapitalisierung belgischer Koordinationszentren.

Nach belgischem Steuerrecht werden Zinszahlungen für Darlehen, die von der Direktion einer Kapitalgesellschaft oder Teilhabern einer Privatfirma gewährt wurden, insoweit als Dividendenausschüttung betrachtet, als der Gesamtbetrag dieser Darlehen das eingezahlte Kapital und die versteuerten Rücklagen zu Jahresbeginn überschreitet (Artikel 18, 3 ITC). Aufgrund der Simulationstheorie ist eine Umqualifizierung von Darlehen als Kapital nur möglich, wenn das Darlehen dem Geschäftsrisiko des Unternehmens ausgesetzt ist. Die Anti-Umgehungsgesetzgebung in Artikel 344, §1 ITC, die seit 31. März 1993 für Übertragungsurkunden gilt, ist ziemlich unklar. Offenbar ist die Umqualifizierung eines Darlehens als Kapital zum Nachweis eines Steuerfaktors wie der Unterkapitalisierung einer Gesellschaft nur dann zulässig, wenn das Darlehen bestimmte kapitalverwandte Merkmale aufweist. Eine spezielle Requalifizierungsmassnahme wie die in Artikel 18, 3 ITC vorgesehene hat gegenüber den allgemeinen Bestimmungen von Artikel 344, §1 ITC Vorrang. Eine auf betriebswirtschaftlicher Analyse beruhende Umqualifizierung ist nicht statthaft.

Es besteht allgemein auch Übereinstimmung darüber, dass eine Umqualifizierung nicht aus den Verrechnungspreisvorschriften des belgischen Steuerrechts hergeleitet werden kann.

Hinsichtlich der internationalen Aspekte ist die OECD zu dem Schluss gekommen, dass eine Umqualifizierung nicht einer arm's-length-Analyse nach Artikel 9 der Doppelbesteuerungsabkommen zuwiderlaufen darf. Dieser letztere Schutz wirkt sich nicht zugunsten von

Einzelpersonen aus. Die von einem belgischen Unternehmen an die Direktion oder den Teilhaber abgeführten Zinsen (die Empfänger haben ihren Sitz im Ausland, aber das Darlehen zählt zum Vermögen der belgischen Betriebsstätte) könnten als nicht abzugsfähige Dividenden betrachtet werden, aber die belgische Betriebsstätte kann für die Dividenden Steuerfreiheit beantragen. Wenn von ausländischen Steuergesetzen Unterkapitalisierungsregeln vorgeschrieben werden, kann die belgische Obergesellschaft auch geltend machen, dass eine Zinsrequalifizierung sich begünstigend auf die Abzugsfähigkeit der Dividende auswirken muss. Es ist zu befürchten, dass die belgische Steuerverwaltung nicht damit einverstanden ist, so dass das Schiedsgerichtsabkommen der EG zur Vermeidung von Doppelbesteuerung eine Lösung bieten sollte. Eine Umqualifizierung von Zinsen in Dividenden im Zusammenhang mit der Quellensteuerfrage ist nur unter den gleichen Bedingungen zulässig wie die Umqualifizierung nach der belgischen Simulationstheorie, nämlich bei Vorliegen einer Beteiligung am Geschäftsrisiko der kreditnehmenden Gesellschaft. In vielen der von Belgien abgeschlossenen Doppelbesteuerungsabkommen ist eine erweiterte Definition der Dividende enthalten. Die gemäss Artikel 18, 3 ITC umqualifizierten Zinsen für Darlehen von Teilhabern privater Firmen unterliegen der Quellensteuer zu dem für Dividendenzahlungen geltenden Satz. Der Begriff der „Überkapitalisierung“ bezeichnet eine übermässige Eigenkapitalausstattung eines ausländischen Unternehmens in einem Niedrigsteuerland bei gleichzeitiger Steuerbefreiung der ausgeschütteten Dividenden der belgischen Obergesellschaft. Die Simulationstheorie erlaubt die Umqualifizierung einer Kapitaleinlage in Darlehen, wenn sie nicht am Geschäftsrisiko der Tochtergesellschaft beteiligt ist. Die Umbezeichnung von Eigenkapital in Fremdkapital gemäss Artikel 344 §1 ITC ist als eigenständige Transaktion nicht möglich. Unklar ist, ob eine Kapitaleinlage, als Teil anderer Transaktionen, als Fremdkapitalzufuhr betrachtet werden kann, da der Vorgang der Steuerumgehung dient und das Fremdkapital den Charakter einer Drittschuld hat.

Resumen

La Ponencia trata no sólo los aspectos fiscales de la subcapitalización de sociedades, sino también el tema, más amplio, de la recalificación del préstamo como capital. En la introducción, la Ponencia estudia brevemente el tratamiento tributario de los dividendos e intereses, los aspectos no fiscales relativos a un nivel mínimo de capital y la definición de la „sobrecapitalización“. El Real Decreto 187 de 5 de agosto de 1991 intenta impedir la capitalización excesiva a causa de la imposición de los centros de coordinación belgas.

La legislación tributaria belga reclasifica el pago de intereses sobre anticipos otorgados por directores de sociedades de capital y socios de sociedades privadas como distribución de dividendos cuando el montante total de los anticipos sea más elevado que el capital totalmente desembolsado y las reservas ajustadas a principio de año (artículo 18, 3º del Código de Impuestos). Basándose en la teoría de la simulación, sólo puede reclasificarse el capital prestado como capital propio cuando aquél esté sujeto a los riesgos inherentes a las actividades de la sociedad. Las disposiciones del artículo 344, párrafo 1, del Código de Impuestos, sobre lucha contra la evasión y aplicables a los títulos desde el 31 de marzo de 1993, son relativamente imprecisas. Parece que la reclasificación de capital prestado como capital propio, por actos llevados a cabo con fines fiscales tales como la subcapitalización, sólo es válida cuando el capital prestado tiene ciertas características relativas al capital propio. Una medida

de reclasificación específica como la del artículo 18, 3º, del Código de Impuestos, prevalece sobre la disposición general del artículo 344, párrafo 1, del mismo. No se autoriza la reclasificación basada en un análisis económico.

Por otra parte, se admite generalmente que la reclasificación no puede basarse en la legislación tributaria belga sobre precio de transmisión.

Habida cuenta de los aspectos internacionales, la OCDE ha concluido que la reclasificación no puede ser contraria al análisis de la empresa independiente que figura en el artículo 9 de los Convenios de doble imposición. Las personas físicas no se benefician de esta última protección. Los intereses pagados por una sociedad belga a su director o socio (tratándose de una sociedad extranjera, únicamente el anticipe es un activo de su establecimiento permanente belga) podrían reclasificarse como dividendo no deducible, si bien el establecimiento permanente belga puede solicitar la exención del dividendo. Cuando la legislación fiscal extranjera imponga normas sobre subcapitalización, la sociedad matriz belga podrá también sostener que los intereses reclasificados han de favorecer la exención del dividendo. Puede temerse que la administración tributaria belga no esté de acuerdo, de manera que deberá aportar la solución el Convenio de la CE sobre arbitraje para eliminar la doble imposición. Sólo se autoriza la reclasificación de intereses como dividendos, en relación con el problema del impuesto anticipado, en las mismas condiciones que la reclasificación según la teoría belga de la simulación: reparto de los riesgos inherentes a las actividades de la sociedad prestataria. Cantidad de convenios de doble imposición concluidos por Bélgica contienen una definición amplia del dividendo. Los intereses reclasificados por anticipos (préstamos) otorgados por socios de sociedades privadas conforme a las disposiciones del artículo 18, 3°, del Código de Impuestos, están sujetos al impuesto anticipado aplicable a los dividendos. El término "sobrecapitalización" hace referencia a la aportación excesiva de capital de una sociedad extranjera beneficiaria de un sistema fiscal privilegiado, mientras que los dividendos distribuidos dan derecho a la exención por dividendos de la propia sociedad matriz belga. La teoría de la simulación permite la reclasificación como capital prestado cuando las aportaciones de capital no compartan los riesgos inherentes a las actividades de la filial.

La reclasificación del capital propio como capital prestado, conforme a las disposiciones del artículo 344, párrafo 1, del Código de Impuestos, como operación aislada, no es posible. No aparece muy claro si la aportación de capital, como parte de diferentes operaciones, podría ser reclasificada como capital prestado cuando el régimen tenga por fin luchar contra la evasión fiscal y el capital prestado presente las características de las deudas.