Belgium

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Summary and conclusions

Belgium plays an important role as a "hub" for global investments and international finance.

With non-tax law determining the classification (and treatment) for tax law purposes and in the absence of "substance-over-form" reclassification mechanisms, the legal (and tax) framework offered by Belgian law provides issuers and investors with the flexibility they desire in relation to creating tax efficient debt, equity and hybrid financing instruments.

Certain structural elements within Belgian corporate income tax (CIT) (notional interest deduction (NID), the exemption of capital gains on shares, an attractive participation exemption regime, the full deductibility of interest payments) allow companies to create the preferred financing and investment mix, whether via debt or equity.

As far as withholding tax (WHT) is concerned, specific exemptions exist which require the attention of investors. Certain non-resident investors (e.g. foreign pension funds) may benefit from a local WHT exemption, which adds to the attractiveness of Belgium. Furthermore, Belgian investors (in relation to foreign dividends) as well as foreign investors (in relation to Belgian source dividends) may be subject to a WHT that is discriminatory based on European Treaty freedoms.

Based on the interpretation of Belgian (case) law as it currently stands, a single contract or legal relationship should not be open for reclassification for Belgian tax purposes under article 344 §1 BITC, provided that:

- the given contract is correctly and rightfully classified as a loan relationship (or equity instrument) following the principles within the Belgian Civil Code and the single benchmark principle of Belgian general (contract) law set out below or the principles of the respective *lex societatis*, with the given parties having accepted all the legal consequences of the contractual relationship entered into (i.e. no "sham doctrine" is applicable);
- the given contract is not open to be rightfully and correctly classified otherwise from the relevant general (contract) or corporate law perspective (e.g.

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as a shareholder's interest or equity contribution, or as a debt instrument) given the distinct corporate law characteristics that would have to be adhered to in such a shareholder relationship (equity) or creditor/debtor relationship (debt) and taking into account the condition that any reclassification should respect all pertinent (or necessarily relevant) legal consequences of the contract entered into;
- the debt (loan relationship) or equity (capital) character of the given contract is supported by sound financial and economic business needs.

As mentioned below, in relation to the advance ruling decisions (ruled in recent years) in the context of profit participating loans (with various hybrid features), the Belgian Ruling Commission has confirmed that the hybrid financing instruments brought before the Commission were not open to be reclassified based on article 344 §1 BITC.

Although no general application can be granted to the given decisions – they are only applicable in this specific context and for the taxpayer who introduced the request – such position may be seen as confirming the position taken below.

1. Overview of regulatory and market conditions

1.1. Belgium as an international "hub"

As a small country, Belgium is often considered to rely on foreign inward investment. If one assesses the role Belgian entities play in today's world of globalised finance, it is evident that there is more to it than just the capital import/capital export divide. Certain measures within Belgian tax law cause Belgium to be an attractive jurisdiction for financing: (a) a vast number of holding companies are located in Belgium as they are attracted by its holding regime; (b) Belgian (finance) companies are often used as a financing "hatch" playing an intermediate role between in- and outbound financing; (c) Belgian entities are key in the strategy of private equity houses when "structuring" their holdings, etc.

Any tax analysis should therefore necessarily focus on both inward and outward financing so as to recognise the specific role of Belgium as an international "hub" (cf. section 2).

1.2. Non-tax law elements

A wide range of debt and equity instruments exist on the Belgian market, regardless of whether inward or outward financing is concerned. Belgian general (contract) and company law certainly allow for (hybrid) features to be included in financing instruments of both a debt and an equity nature.

The degree of flexibility provided by general (contract) and company law (which can be considered higher as far as debt instruments are concerned) and the fact that general (contract) and company law classification determines the classification (and treatment) for tax law purposes (cf. section 3) has clearly added to the development of tax optimised hybrid instruments in Belgium.

From an inward financing perspective, the predominant type of tax optimised hybrid instrument are profit participating loans or securities (PPL(s) or PPS(s)), whereas from an outward financing point of view the existence of (mandatory) redeemable preference shares ((M)RPS) should be mentioned.

As far as the regulatory framework is concerned (applicable in the financial sector), Belgium has subscribed to the Basel, solvency and European capital adequacy approaches. Unlike Belgian general (contract) and company law, there is no direct link between regulatory law classification and tax law classification, with each being a separate set of rules: the tax law classification of an instrument does not depend on its classification for regulatory purposes. Nevertheless, it must be clear that the (stricter) "equity" features which are required nowadays from a regulatory perspective in order to have instruments classified as capital indirectly play a role in the (legal and tax) design of hybrid instruments: they have made it less possible to come up with hybrid financing instruments treated as capital from a regulatory point of view but as debt from a tax perspective.

The current legal (and tax) framework offered by Belgian law provides issuers and investors with the flexibility they desire in relation to developing debt, equity and hybrid financing instruments. As a result, the need to develop other and less straightforward solutions (e.g. via investment units, stapled or compound instruments, partnerships and partnership certificates) has been less apparent than in other jurisdictions (e.g. Germany with silent partners being treated as mere debt investors).

1.3. Special investors: pension funds, collective investment vehicles and tax exempt investors

Pension funds, collective investment vehicles and other tax "exempt" investors are important market participants.

For non-resident investors of this type investing in Belgium, the availability of local WHT and exemptions may be key (cf. section 2). In addition, the discriminatory Belgian WHT treatment which some of them (e.g. foreign collective investment entities) bear is currently the subject of much controversy. Resident pension funds and collective investment corporations investing domestically are still hampered by the WHT which they bear in relation to domestic dividends (which is only later credited and refundable via their corporate income tax return). When they invest cross-border, treaty entitlement on the one hand and discriminatory (foreign) WHT on the other hand are among the most important elements in current practice (cf. section 2).

1.4. Financial and fiscal instability – European Code of Conduct

Given the financial instability and more particularly the euro crisis, Belgium has launched a 2012 budget which includes a vast number of tax measures, *inter alia* increased WHT, a reshaped NID with a lower/capped rate and changes to the carryforward of unused NID, general thin capitalisation rules in relation to intragroup debt financing, the introduction of a minimum holding period in order to benefit from the exemption of capital gains on shares, etc.

Furthermore, government negotiations have led to an agreement on revisiting the current general anti-avoidance rule in the Belgian Income Tax Code (BITC) for a more substance related doctrine inspired by *fraus legis*. It remains to be seen what the impact on the debt–equity divide (and hybrid financing instruments) will be.

In relation to (payments on) cross-border hybrid financing instruments that give rise to double tax benefits (e.g. a profit participating loan resulting in deductible interest expenses in one jurisdiction and eligibility for the participation exemption in another), further scrutiny by the European Commission has also been announced in the context of the Code of Conduct (on harmful tax competition). Depending on the outcome of this scrutiny, the solutions currently available on the Belgian market may be affected.

2. Summary of key tax principles

2.1. In search of the right financing mix

From a corporate tax perspective, a Belgian corporate entity seeking (inbound) financing may opt for instruments classified as debt (generally resulting in the deductibility of interest payments paid to debt holders as business expenses), for instruments classified as equity (eligible for NID, which is a notional deduction calculated on the issuer's equity for tax purposes) or for a mix of both debt and equity financing.

When a Belgian corporate entity acts to provide (outbound) financing, again both debt and equity financing can play a role. Although a debt investment in principle gives rise to taxable interest income, outward debt financing still provides an option to be considered, as under Belgian tax law the equity basis on which the NID (see below) is calculated does not need to be corrected in respect of debt investments (whereas such is in principle the case for a company's equity investments). For outward equity investments, dividends received by a Belgian corporation benefit from the participation exemption (subject to "subject to tax" and "minimum holding" conditions), whereas capital gains on such equity investments are exempt under Belgian tax law (subject to the same "subject to tax" conditions).

The existence of the NID can be considered a unique measure which is one of the structural elements of CIT. As such, Belgium can be seen as having introduced a specific tax regime affecting the debt–equity mix at the core of its corporation tax.

2.2. Key tax "structural" principles

2.2.1. Corporate income tax treatment (general)

2.2.1.1. Treatment of the issuer – deductible interest payments v. NID

2.2.1.1.1. Debt – deductibility of interest payments

In Belgian tax law, as in other jurisdictions, income tax on business income is calculated on a net income figure (cf. article 49 of the BITC accepting the deductibility of business expenses). Financing costs are among the business expenses which are considered as deductible *per se* with article 52(2) BITC reading as follows (non-official translation): "interest on loan capital, borrowed from a third party and used within the business, is deductible as are other charges, returns and similar payments with respect to that business".

Correspondingly, the terms "interest", "loan capital" and "borrowed" need further interpretation and clarification. The BITC as well as the Royal Decree implementing it (RD/BITC) remain largely silent in this respect. Inspiration for the term "interest" can be found in article 19 §1(1) BITC (which is the basic definition of the taxable status of interest in individual income tax): here, "interest" is defined as "interest, premiums and any other proceeds from loans including from the granting of collateral on financial instruments, from deposits and from any other receivable" (free translation). Following this definition, it must be noted that taxable interest does not necessarily have to relate to proceeds generated from a contractual relationship evidenced by a loan agreement: payments qualify as interest when their underlying source is a receivable which does not meet the Civil Code definition of loan, in principle requiring the repayment of the nominal value/principal amount which has been invested (see section 3 below).

The BITC provides for a number of limitations on the rule of deductibility of interest payment relating to the at arm's length character of the interest rate used, the location of the recipient in a tax haven jurisdiction, etc. Given the more general requirements of this analysis, specific limitations on the interest deduction will not be discussed further (refer to the 2008 Belgian report of P. Smet).[1]

2.2.1.1.2. Equity – NID

Unlike interest payments, dividend payments are not deductible in the hands of a distributing company. In this respect, article 185 §1 BITC includes the following (non-official translation): "Corporate entities are taxable on the total amount of their profits, distributed dividends included".

[1] P. Smet and S. Martin, Belgium report, in International Fiscal Association, *New Tendencies in Tax Treatment of Cross-border Interest of Corporations* (*Cahiers de droit fiscal international*, vol. 93b), pp. 127–149. The following limitations on the deductibility of interest payments require a reader's specific attention, for example interest payments which do not meet certain arm's length conditions (also resulting in a reclassification in dividends), interest paid to low-taxed beneficiaries (subject to a 7:1 debt–equity ratio).

However, since the accounting year 2006 (assessment year 2007) Belgian corporate entities as well as Belgian branches (permanent establishments of non-resident companies)[2] have been entitled to an NID, which is considered to narrow the discriminatory treatment between equity funding and debt funding and to provide an alternative to the former Belgian coordination centre regime.

The NID does not give dividends a deductible character as such. Subject to some specific reporting formalities, it consists of a deduction for equity capital which is determined on a "notional" basis and amounts to a certain (risk free) interest percentage (in principle relating to 10-year government bonds) of an entity's net equity base (capital and reserves), in accordance with its preceding year non-consolidated Belgian generally accepted accounting practice (GAAP) accounts.

Modifications in the net equity during an accounting year are taken into account on a pro rata basis as from the first day of the month following the month during which the modification took place.

The company's net equity base is subject to some adjustments and limitations for tax (i.e. NID) purposes, by means of which Belgian draftsmen attempted to limit the application of "multi-stage" benefits as well as the artificial "pumping up" of a company's equity base. For example, these may include shareholdings in other companies qualifying as financial fixed assets under Belgian GAAP, shares in investment companies of which the dividends qualify for the participation exemption, investments in own shares (all for their net tax value); foreign (non-Belgian) permanent establishments and investments in foreign landed property, subject to their income being exempt from Belgian income tax pursuant to an applicable double tax treaty (DTT) (for their accounting value); passive investments (for their net accounting value), that is to say mere investments (not related to the business purpose of the entity concerned) and which by their nature are not aimed at generating taxable income periodically (e.g. accumulating shares or units).

Given budgetary constraints, the NID rate has been capped by Royal Decree at a maximum of 3.8 per cent for assessment years 2011 and 2012 (accounting years 2010 and 2011) by Royal Decree. The rate effectively confirmed for assessment year 2012 is 3.425 per cent. For "small" companies, the NID rate is increased by 0.5 per cent (which means 3.925 per cent for assessment year 2012).

If there are insufficient profits to offset the available NID, any unused portion can be carried forward for seven years.

2.2.1.2. Treatment of the investor – taxable interest income v. participation exemption

2.2.1.2.1. Debt – taxable treatment

Interest income (both received and accrued) is included in a corporate entity's tax base (measured on the basis of Belgian GAAP) and taxable at the standard CIT rate of 33.99 per cent. As mentioned above, subject to the given entity being financed with equity capital, an NID may serve to considerably reduce the tax charge on such interest income (together with other standard deductible items, such as inter-

[2] For branches of non-resident corporate entities, it is the allocated capital, accounted for as capital in line with Belgian GAAP, which serves as the basis for the NID.

est expenses, carryforward of tax losses, etc.). The tax charge on foreign interest income is further reduced via a foreign withholding tax credit (FTC) calculated on the basis of a maximum foreign WHT of 15 per cent while applying a limitation referring to the financing ratio of the creditor.

2.2.1.2.2. Equity – dividend received deduction and tax exemption of capital gains on shares

Belgian tax law provides for an elimination of dividends from the taxable base for 95 per cent (via a deduction of dividends received, hence often referred to as "dividend received deduction") in order to counter economic double taxation (cf. articles 202–205 BITC). Such a measure has existed for a long time in Belgian tax law, but it had a major overhaul in 1991 when implementing the European Parent–Subsidiary Directive. In order to benefit from this "dividend received deduction", both "minimum holding" and "subject to tax" conditions apply. In principle, the regime does not formally distinguish between Belgian source and foreign source dividends, but when applying the rules in practice certain distinctions come to the fore. *Ratione materiae* both symmetrical dividends (recurring or standard dividend distributions (cf. article 202 §1(1) BITC) as well as (Belgian and foreign) asymmetrical dividends (related to specific corporate "realisation" events resulting in the termination of the participation, e.g. redemption or buyback of own shares giving rise to a redemption surplus, partial or total liquidation leading to a liquidation surplus (cf. article 202 §1(2) BITC), can benefit from the participation exemption regime. A number of items (e.g. disallowed expenses) are identified in article 205 §3 BITC against which the dividend received deduction cannot be set off. Since 1 January 2010, article 205 §3 allows for an (indefinite) carryforward provision for unused "dividend received deduction" for Belgian and EU source dividends (with the treatment for non-EU dividends in principle still depending on the relevant DTT).

Realised capital gains on shares (in accordance with article 192 §1 BITC) are fully exempt from the corporate tax basis if the "subject to tax" conditions are met (which also apply for the "dividend received deduction"). Up to now, no "minimum holding" requirements have applied in relation to capital gains on shares.

According to article 202 §2 BITC, 95 per cent of dividends received may indeed be claimed as participation exemption if the following (so-called) "minimum holding" conditions are met:

(a) the given dividend should be declared by a company in which, at the time the dividend is attributed or made payable, the beneficiary has a minimum shareholding of 10 per cent or a shareholding whose acquisition value was at least 2,500,000 euro; and
(b) the beneficiary should have had full legal ownership (e.g. not a usufruct) of the underlying shares for an uninterrupted period of at least one year before the dividend distribution or the beneficiary makes known his commitment to hold the shares for a minimum of one year.

Article 203 §1(1)–(5) BITC identifies five groups of "subject to tax" conditions (consisting of "negative cases" referring to the entity invested in or distributing dividends) for which no exemption can apply. Subject to doctrinal discussions, these conditions have been subject to a number of advance ruling decisions applicable to a specific tax regime (for example, regarding some specific and/or temporary regimes, regarding jurisdiction applying territoriality principles, etc.). No exemption exists:

- if the entity concerned is (a) not subject to Belgian resident CIT or (b) to a foreign tax similar to the Belgian CIT; or (c) has its residence in a country where the standard tax regime is substantially more advantageous than in Belgium ("tax haven");
- if the entity concerned is a financial company, a treasury company or an investment company which, although tax resident in a jurisdiction in which it is subject to a tax equivalent to Belgian CIT, benefits from a tax regime which is different (distinct) from the common CIT regime;
- if (a) the income that the given entity receives, other than dividends, has been generated outside its country of residence and (b) it benefits in the country of its residence from a tax regime that is different from the common tax regime;
- when the entity generates profits through one or several foreign permanent establishments, if these profits are "on a global basis" (i.e. the cumulated tax charge on such profits at the level of both the foreign permanent establishment office and its head office) subject to a tax regime that is substantially more favourable than that in Belgium;
- when the entity (not being an investment company) redistributes dividend income which would not qualify for the participation exemption based on the points above for the 90 per cent "transparency" principle.[3]

2.2.2. WHT (general)

2.2.2.1. Interest WHT

The standard WHT rate for interest payments is 15 per cent. No general exemption applies to cross-border interest payments. Such interest payments can only benefit from a Belgian WHT exemption based on specific exemptions in Belgian tax law referring to the nature of (a) the debtor, (b) the creditor (e.g. an "intra-group" bank) and/or (c) the debt instruments (e.g. registered bonds). For example, exemptions exist for interest payments (by a Belgian company) to credit institutions in the EEA or in a Treaty jurisdiction, interest payments to a number of well-defined recipients (*inter alia* non-resident investors) in relation to debt securities issued via the Belgian X/N clearing system, interest payments to related qualifying EU entities subject to certain holding conditions (following the implementation of the EU Interest and Royalty Directive), etc. Treaty-wise, it should be noted that few DTTs provide for a full WHT exemption (e.g. the Belgium–USA DTT).

2.2.2.2. Dividend WHT

The basic WHT rate for dividends amounts to 25 per cent. A reduced WHT rate of 15 per cent is available subject to conditions (for example, on dividends relating to non-preference shares publicly issued as of 1 January 1994, dividends on non-preferred registered shares subscribed in cash upon issue as of 1 January 1994).

[3] It should be noted that each of the conditions mentioned above is subject to specific requirements and interpretations, which are beyond the scope of this report.

As far as cross-border dividends are concerned, the Belgian implementation of the Parent–Subsidiary Directive should be mentioned, resulting in an exemption of WHT on dividends paid to qualifying EU parent companies (subject to certain holding conditions). Since 2007 and subject to the same conditions, Belgium has broadened the scope of this exemption to qualifying parent companies located in a jurisdiction with which Belgium has entered into a DTT (including a relevant "exchange of information" provision).

2.2.3. CIT treatment (special investors)

As far as Belgian special investors which have the form of a collective investment corporation (BEVEK/SICAV) or pension funds (denominated OFP in Belgium) are concerned, article 185*bis* BITC provides for a special corporate in regime. They are subject to Belgian CIT but on a limited taxable base, which consists only of (a) abnormal or gratuitous advantages obtained and (b) disallowed expenses (except for realised/unrealised capital losses on shares). As a consequence, investment income or gains are not included in the taxable base. The taxable income (which is usually nil in the absence of abnormal or gratuitous advantages or disallowed expenses) is subject to the standard CIT rate (at 33.99 per cent). Secret commission payments, if any (in principle not), are taxable at 309 per cent (as unjustified expenses). Correspondingly, the given entities (often) do not pay CIT in practice.

When investing domestically, the given entities are still hampered by the WHT which they bear on Belgian source dividends as no exemption is available at source: the given WHT is only creditable (and refundable, in case of excess) via the CIT return. A change of law has been anticipated for some years now.

As BEVEKs/SICAVs and OFPs have separate legal personality and are subject to CIT, they are generally treated as entitled to the benefits of DTTs: reduced treaty rates should be applicable (on cross-border dividends) in the jurisdiction of source.[4]

Following European case law, the WHT which Belgian BEVEKs/SICAVs and OFPs bear on European source dividends (and which cannot be refunded under existing DTTs or credited against the Belgian entities' CIT because of a DTT) should be seen as discriminatory if the entities' foreign counterparts are either not subject to the same WHT or eligible to have such WHT credited/refunded.

2.2.4. WHT (special investors)

Dividends paid by Belgian collective investment vehicles are subject to a WHT rate of 15 per cent.

In relation to outbound dividends paid in relation to Belgian shares, article 106 §2 of the RD/BITC provides for a domestic WHT exemption in relation to dividends paid to non-Belgian entities that do not run any business or are not involved in profit-making transactions and that are exempted from income tax in their country of residence. This provision applies to foreign pension funds, charitable organisations, etc. The main conditions are the following:

[4] In some countries, the tax authorities are currently questioning the given entities' eligibility for the benefits of DTTs based on their limited tax base which does not include dividend distributions. It is *inter alia* because of such questions that treaty entitlement of collective investment vehicles is currently high on the OECD's tax agenda.

- the debtor must be a company, association or establishment which has its principal seat of management in Belgium;
- the beneficiary must be a non-Belgian resident taxpayer that has not attributed its assets to its professional activity in Belgium;
- the beneficiary may not run a business nor be involved in profit-making transactions;
- the beneficiary must be exempt from income tax in its country of residence.

Further to the conditions above (and certain reporting obligations), article 106 §4 RD/BITC also provides for an anti-avoidance measure: the non-resident recipient of the dividends cannot have a contractual obligation to pass on the income to some other beneficial owner (or "ultimate beneficiary" as the Belgian tax legislation expressly states in this context). This anti-avoidance measure has come into place to make sure that the given domestic exemption is not used by an eligible non-resident investor acquiring Belgian shares in its own name while having entered into a contractual relationship with a third party "on behalf of which" the shares had been bought and to whom the benefits must be passed on.

The discriminatory foreign WHT that is mentioned above in relation to certain Belgian entities receiving foreign source dividends should also be mentioned in respect of certain foreign entities (such as collective investment vehicles) bearing Belgian WHT that is not creditable/refundable on the basis of a DTT in their country of residence (whereas their Belgian counterparts are eligible for a WHT credit or refund, cf. section 2.2.3 above). Both situations (in- and outbound) are currently under increased scrutiny from the European Commission.

3. Classification as debt or equity

3.1. General classification principles

3.1.1. In search of benchmark principles

No clear definitions or specific guidance (e.g. in administrative commentaries or decisions, in case law) exist in Belgian tax law according to which (hybrid) financing instruments can be classified.

Nevertheless, Belgian tax law requires distinguishing between debt and equity (as well as between interest payments and dividends) in order to apply the correct (and distinct) tax treatment applicable to both sources of finance and their service/remunerating payments, i.e. interest and dividends (cf. section 2).

In the absence of clear legislative guidance and case law (for tax purposes), one should necessarily proceed on the basis of the "benchmark" principles rooted in the Belgian Civil Code, which sets out the general (contract) law principles governing loan relationships, and the Belgian Company Code, which sets out the basic company law framework.

Two basic premises are important in relation to the debt–equity divide: (a) the dependence by tax law on the general (contract) and company law classification and (b) the adherence to the legal form (*la realité juridique* – see section 3.1.3 below).

3.1.2. Dependence on the legal form according to general (contract) and company law

As a rule, Belgian tax law respects the legal classification attaching to a contract for general (contract) or company law purposes, only setting it aside when the BITC provides for a specific tax definition. This binding principle is grounded in a landmark decision of the Belgian Supreme Court (*Cour de Cassation*) of 1931 in which it was held that (free translation): "The principles of general law rule tax law, as far as tax law did not deviate from such principles itself; they are applicable … even if they are based on a fictional provision within general law."

3.1.3. Classification based on legal form

The second general principle which is applicable in the context of classification for Belgian tax law purposes can be expressed by the adage "le droit fiscal se fonde sur les réalités". This means that a given classification within Belgian tax law purely depends on the legal form (*la realité juridique*). No "substance over form" principle exists under Belgian tax law: the tax treatment of a given transaction/contract cannot be based on the economic reality or substance (*la realité économique*) setting aside the legal reality or form of the given transaction/contract.

As a consequence, any classification under Belgian law necessarily starts with a formal legal search for the criteria that are decisive for the classification under non-tax law, i.e. general (contract) or company law. In that sense, classification of (hybrid) financing instruments according to Belgian law can still be considered as a "categorical prototype" classification searching for the "core" and the "periphery".

3.1.4. Form over substance

These premises apply to both debt and equity instruments. They have resulted in the Belgian tax system being termed a "form over substance" regime, not least in the context of hybrid financing instruments.

Below, classification in respect of debt instruments (section 3.2) will be dealt with first, followed by the classification principles for equity instruments (section 3.3). As mentioned in the introduction, the classification of debt will be treated from an inbound financing perspective, i.e. with Belgian resident issuers aiming to deduct interest payments on their debt financing. In relation to the classification of equity, the perspective changes to outbound financing, with Belgian investors seeking to apply equity treatment (i.e. exempt capital gains on shares and the participation regime in respect of dividends received) to instruments issued by foreign (i.e. non-resident) issuers.

3.2. Debt classification – the search for a safe harbour ("one decisive element")

3.2.1. No "weight all the circumstances" approach

From a theoretical perspective, it is the reporter's view that the Belgian classification of "loan relationships" can be reduced to an examination of whether or not a given sole decisive element can be identified (see below). Unlike an "all facts and circumstances" approach, under which instruments are categorised according to whether they have more "debt" or "equity" features according to several benchmark principles, such a "one element" approach uses only one decisive feature as its benchmark test.

As a consequence, as soon as such single benchmark test is identified, it should be possible to reach a "safe harbour" for loan relationships. This means that – notwithstanding the "equity economics" of a given (hybrid financing) instrument and as long as the single benchmark test for a classification as a loan relationship is met – the instrument should be given the tax treatment of a debt investment.

It also means that "facts and circumstances" which are identified as outside the scope of the benchmark test are irrelevant for classification purposes. Correspondingly, certain "structured" financial instruments that prove to be valuable in another tax jurisdiction are not necessarily of equal value in Belgium (e.g. hybrid financing instruments comprised of investment units).

Below will be described how, in the reporter's view, the classification of "loan relationships" for Belgian tax purposes (as based on non-tax law) is indeed to be regarded as based on a "one decisive element" approach, that is to say "the right of the lender to be repaid the initial outlay (or principal amount) at least and possibly only in the case of a *concursus creditorum*".

3.2.2. Belgian non-tax law classification in respect of loan relationships

3.2.2.1. Two basic obligations within the Belgian Civil Code

According to Belgian general (contract) law, a loan relationship is characterised by two basic obligations relating to each party of the loan agreement:

- the first basic obligation is the obligation of the lender (creditor) which marks the start of the loan relationship and which consists in the delivery (transfer) of the goods lent;
- the second basic obligation is the obligation of the borrower (debtor), which consists of the restitution or the repayment of the given goods marking the end of the loan relationship.

From the latter, it follows that in principle a repayment at maturity of the goods lent (i.e. at the end of the term) is a basic requirement for a contract to qualify as a loan agreement.

Notwithstanding the second basic obligation (requiring the repayment of goods lent at maturity), the Belgian Civil Code (in articles 1909 to 1914) also recognises a specific type of debt contract/loan relationship (*eeuwigdurende rente* or perpetual interest), in which the absence of a stated maturity date does not lead to the classification of the given agreement as a loan agreement being disallowed.

As will be explained below from a non-tax law point of view, the undated term is to be reconciled by reference to the contractual clauses in the debt contract (a) in which the creditor (lender) on the one hand agrees not to demand the end of the contract (i.e. by requesting the repayment of the money/goods lent), and in which (b) the debtor (borrower) on the other hand sets aside his entitlement to redeem/repay the money borrowed.

Both are rights which the Civil Code as a rule grants to each contract with an indefinite term: if no such clauses had been agreed upon, general law principles would indeed come into play allowing each party affected (or weakened) by the lack of a fixed term (*in casu* both the debtor and the creditor to the perpetual debt contract) to terminate their undated contractual relationship (at any time and at their sole discretion).

Referring to the second basic obligation mentioned above (i.e. the borrower's obligation to repay the goods borrowed), the following questions should be asked both from a lender's and a borrower's perspective:

- if and when is the lender (creditor) effectively entitled to claim for the repayment of the principal; and
- if and when will the borrower (debtor) effectively be required (and/or entitled) to repay the principal.

The answer to these questions is related to the identification of which of the parties to the given loan agreement (lender and/or borrower) is actually favoured by (the lack of a) maturity date. Or, defined the other way round, which party can be considered to suffer from the (un)dated character?

If one examines the various formulae a loan agreement may have as far as term or maturity are concerned, it will become clear that a "stated maturity" cannot be considered a decisive factor in order for a contract to be classified as a loan agreement (debt) according to Belgian general law (and consequently tax law). The analysis below will show that the Belgian Civil Code certainly allows loan relationships with a "perpetual", or better, "indefinite" term.

3.2.2.2. Loan relationships with a stated maturity

When a loan relationship comprises a stated maturity date, two main non-tax law consequences can be derived (related to both the perspectives listed earlier).

First, a maturity date protects the borrower against a claim from the creditor: only at the given maturity date is the latter unconditionally entitled to require payment of the principal.

Secondly, a maturity date gives the borrower the assurance and protection that he can step out of the debt position at the maturity of the loan by repaying the goods lent. In relation to this assurance, one may ask whether the debtor is – from a general (contract) law perspective – entitled to repay the principal before the term of the loan agreement ends (i.e. matures). According to article 1187 of the Belgian Civil Code, a fixed term in a contract is assumed to be contracted in favour of the debtor (borrower), unless the particular facts of the contract show that the term is also concluded in favour of the creditor (lender). In respect of loan agreements, this means that – even in the case of a stated maturity – a debtor (borrower) is only entitled to repay the goods lent beforehand if it can be argued that the fixed term does not have advantages for the creditor (lender). If the terms of the loan agreement include other obligations for the debtor apart from the repayment of the principal (more particularly, the obligation to make recurrent interest payments) this is not the case. The obligation for the borrower to pay interest to the lender during a fixed term results in the latter being protected and guaranteed this interest remuneration until the loan matures. As such, a restitution or repayment before maturity would not be possible from a general (contract) law point of view.

3.2.2.3. Loan relationships without a stated maturity

If the loan relationship does not include a fixed term, the perspectives above require a different assessment. As already mentioned, the essence of contracts without a fixed term is their "terminability", which means that the "weaker party" to a contractual relationship (i.e. the party to the contract which is detrimentally affected by the absence of any fixed term) should by law be granted the right to terminate it. But which contracting party is affected by the lack of a stated maturity?

According to general (contract) law, the lender is in principle considered to be the contracting party weakened by the lack of a stated maturity. As a rule, he should therefore be allowed to demand repayment by reclaiming the goods lent from the borrower at his discretion and at any time. However, the Belgian Civil Code contains a rule enabling the courts to moderate a request to be repaid and has the option to grant the borrower (when facing a demand for repayment from the lender) a delay depending on the circumstances of the situation at hand (article 1900 Belgian Civil Code).

Although the lender is entitled to demand repayment when no fixed term is agreed, article 1909 of the Belgian Civil Code also provides that – when entering into a loan relationship in return for the payment of interest – it may stipulate that it will not demand or require the repayment of the principal. In the Belgian Civil Code, the contract is then termed the "establishment of interest" (*de vestiging van rente*). If the contract does not include any stipulation on the term or period of the "interest established" (according to article 1909 of the Belgian Civil Code), the contract is called "perpetual interest" (*eeuwigdurende rente*, cf. articles 1910–1913 Belgian Civil Code).

When is the borrower (debtor) entitled to repay the given principal in the context of a "perpetual interest"? Article 1910 of the Belgian Civil Code holds that in principle a loan agreement (establishing perpetual interest) "remains as a rule redeemable by the borrower", notwithstanding the fact that the lender (creditor) has agreed not to demand repayment. The reason for the given right to redeem such perpetual loans lies again in the fact that no party (*in casu* a borrower) can be held to be obliged indefinitely (cf. above). The weaker (interest paying) party must therefore be granted the possibility to opt out of an undated loan agreement.

Although the Belgian Civil Code proclaims the "redeemable nature" of an undated loan agreement, there should be nothing against the borrower (debtor) himself opting to waive this right. However, and given the importance of the "redeemable nature", article 1911 paragraph 2 only allows such a waiver to be partial or limited. More specifically, the article determines that contracting parties can agree that no redemption will be made on the debtor's (borrower's) own initiative before a certain term has passed which cannot be longer than 10 years. So after 10 years the loan (which is the basis for the "perpetual interest") should again become redeemable at the debtor's discretion.[5]

An even more important provision of the Belgian Civil Code holds that – regardless of the lender (creditor) having stipulated not to claim back the goods

5 Another way of tempering the debtor's right to redeem at any time would be to conclude that no redemption is possible by the debtor without due notice to the creditor (art. 1911 Civil Code).

lent – the borrower (debtor) is always obliged to repay the principal in three circumstances which relate to situations of default (cf. articles 1912 and 1913 of the Belgian Civil Code): (a) if the borrower (debtor) does not fulfil its obligations for two consecutive years (e.g. no contractually agreed interest was paid for two years); (b) if no contractually promised collateral is provided; or (c) in case of bankruptcy (*concursus creditorum*).

3.2.3. Benchmark – the right of the lender to be at least repaid the initial outlay, possibly only in case of a concursus creditorum

This brings us to the question of whether – from the above-mentioned provisions and principles regarding "perpetual interest" and loans without a "stated maturity" – a single decisive benchmark test can be derived, which is applicable not only in relation to perpetual debt securities (or undated loan relationships) but to other types of hybrid loan relationships as well (for example, profit participating loans).

In this respect, the reporter would like to refer to the Belgian scholar Haelterman who points to the fact that a loan relationship becomes due in case of a bankruptcy (also in the absence of a stated maturity) as the decisive element for the purposes of classification. According to his view, the theoretical possibility to require repayment (even if only in case of default or *concursus creditorum*) can be considered to be decisive for an instrument's classification as debt.[6] In order to classify perpetual bonds, other scholars have similarly argued that "the obligation to repay the loan is one of the key characteristics of debt instruments as opposed to equity".[7]

On the question of the "benchmark" test used by Haelterman, it has been shown above that the Belgian Civil Code provides for a legal framework to enter into a "perpetual" loan agreement with (a) the lender (creditor) waiving its right to demand repayment, (b) the borrower (debtor) setting aside its right to repay via a non-redemption clause up to 10 years (after which its discretionary right to repayment revives) and (c) the initial outlay (or principal) becoming repayable in case of default and *concursus creditorum*. This means that even if a loan relationship has no fixed maturity on which the initial outlay will mandatorily be repaid (or become repayable) and repayment of the principal will only occur at the discretion of the debtor/borrower (after some possible non-redemption clause has been forgone) or in cases of default or *concursus creditorum*, the contractual relationship does not lose its classification as a loan relationship.

Fully in line with the general (contract) law principles (as rooted in the Belgian Civil Code) set out above, one can argue that when a lender has the right to be repaid the initial outlay at least and possibly only in case of a *concursus creditorum*, the given contractual relationship can still qualify as a loan relationship.

6 A. Haelterman, "Quelques réflexions sur la notion d'intérêt à la lumière de quelques nouveaux instruments de placements et de financement", *Revue de droit de l'U.L.B.*, 1999 (79) p. 89.

7 H. Lamon, F. Weynants and D. Berckmans, "Tax Treatment of Debt Instruments without Fixed Right to Redemption", *Derivatives and Financial Instruments* 2001 (143) 163.

3.2.4. Applying the "benchmark" to other loan relationships

The next question one must ask is how the above-mentioned "benchmark test" can apply to other debt instruments on the market, such as:

- instruments with a fixed maturity date at which the given loan relationship mandatorily converts into shares of the issuer or converts into its own shares at the option of the issuer (borrower), that is to say mandatory convertible instruments and reverse convertible instruments;
- instruments with a fixed maturity date at which the proceeds invested (initial outlay) are repaid according to some formula linked to the performance of the issuer (as included in the terms and conditions of the instrument), without the guarantee of being repaid the nominal value.

It is the reporter's view that in order to be classified as a loan agreement, the lender (creditor) should (in accordance with the benchmark test) always have the right to be repaid its initial outlay in case of a *concursus creditorum*. In other words, the lender (creditor) should always have a debt claim for the full nominal value (only taking into account general subordination principles and subject to general bankruptcy rules): as far as this debt claim is concerned, no downward adjustment should be possible.

If, for example, the terms and conditions of a debt instrument mandatorily redeemable in shares contain a provision which – regardless of the repayment formula at maturity date – holds that in case of a *concursus creditorum* the entitlement to be repaid the original outlay (debt claim) will revive, the given instrument should – in the reporter's view – be granted debt status as a loan relationship.

3.2.5. Softening the single benchmark test

Above it was demonstrated how, in the reporter's view, one can reach a "safe harbour" in relation to a debt classification (and the corresponding deductibility of interest payments) by way of a loan agreement. Nevertheless, both tax law as well as ruling practice have come to soften this strict "single benchmark" test.

First, article 19 §1(1) BITC (including the standard definition of taxable interest, cf. above) refers to "interest, premiums and any other proceeds from loans … and from any other receivable" (free translation). As such, it must be noted that taxable interest does not necessarily have to relate to proceeds generated from a contractual relationship evidenced by a loan agreement: payments also qualify as interest payments when their underlying source is a receivable which does not meet the Civil Code definition of loan agreement (as set out above). Correspondingly, it seems accepted among scholars and in practice that in order to deduct interest payments in the CIT of an issuer (or debtor/borrower), a mere receivable as an underlying source should also be sufficient (not requiring the repayable character of the nominal value/principal amount which has been invested).

This can also be noted in ruling decisions in relation to tier 1 securities (being debt from a tax perspective and capital from a regulatory/rating perspective) and in respect of PPLs or PPSs, where for classification purposes a less strict adherence to the repayment of the nominal value (original outlay) has been applied. Other elements have also been taken into account (e.g. that the instruments were marketed as debt instruments, that the instruments were invested in by investors not allowed to invest in non-debt securities, etc.).

Although based on such rulings and some literature, the impression may arise that Belgian tax law applies an "all facts and circumstances" approach to decide whether an instrument qualifies as debt or equity, it should be stressed that general (contract) law and company law evidence otherwise.

In the context of ruling decisions related to PPLs or PPSs, parties specifically sought a classification as debt in the hands of the issuing Belgian entity giving rise to deductible interest payments while obtaining an equity classification in the jurisdiction of the investor (resulting in a corresponding equity treatment, mostly in Luxembourg).[8] Asked to pronounce on the debt character of these instruments, the Ruling Commission explicitly confirmed that in the absence of specific provision in tax law, the classification of an instrument as debt (resulting in deductible interest payments for tax purposes) should be based on the classification according to general (contract) law (i.e. the provisions governing loan relationships in the Belgian Civil Code).

Apart from the confirmation of the principle mentioned above (i.e. the dependence on the classification according to non-tax law), the given advance ruling decisions are also relevant for the following reasons:

- first, they show that the vast majority of hybrid (or must one say equity) characteristics are irrelevant as far as distinguishing between debt and equity is concerned (e.g. subordinated character, profit participating and profit depending character of interest payments, reverse conversion in shares (on demand of the issuer), an undated term if the loan were not repaid at the first maturity (or call) date, etc.;[9]
- secondly, they also confirm that the basic anti-avoidance provision in the Belgian tax law does not apply to the given profit participating loans and are therefore not open to be reclassified (cf. section 3.4 below).

Having again mentioned reclassification, the reporter would like to conclude by reverting back to article 19 §1(1) BITC and the fact that deductible interest does not necessarily have to relate to proceeds generated from a contractual relationship evidenced by a loan agreement (see above). Whereas the correctness of that position should not be subject to discussion, it must be clear that from a "safe harbour" perspective on the one hand and the risk of reclassification on the other hand, a difference in degree seems to exist between debt evidenced by a loan agreement according to general (contract) law and debt merely evidencing a receivable, for example because of the initial outlay being subject to the "risk of the corporate venture" (without a guaranteed debt claim in case of a *concursus creditorum*).

8 Pioneer ruling decisions include Advance Ruling Decision 600,099 of 4 May 2006 and Advance Ruling Decision 700,065 of 5 June 2007.

9 The given advance ruling decisions, however, do not enter into the question how classification according to Belgian law should take place (positive argumentation), which we have engaged in for the purposes of this report via a search for the "one decisive element" based on Belgian general/corporate law.

3.3. Equity classification – is there a "safe harbour" as well?

3.3.1. Classification according to the lex societatis

The basic principle mentioned earlier also applies in the context of classifying equity instruments with tax law as a rule adhering to the classification of general (contract) and company law.

In a Belgian context, the application of this rule necessarily points to Belgian non-tax law governing the tax law classification (and treatment). In a cross-border context with a Belgian investor having invested in a foreign equity instrument, the given principle raised the question of which general non-tax law should be seen as decisive from a tax point of view.

For the purposes of Belgian tax law, financing instruments should in principle be classified according to the *lex societatis* principle of international private law. This means that the classification (and treatment) for Belgian CIT purposes depends on the financing instruments' general (corporate) law classification within the jurisdiction in which the (non-resident) issuer is located.

Since the Act of 16 July 2004 (published in the Belgian Official Gazette on 27 July 2004), reference can be made to the Belgian Code of International Private Law: article 111, paragraph 7 of this Code holds that the *lex societatis* is applicable in relation to determining who is to be considered a shareholder of a foreign corporate entity.

According to the reporter's view, no rules exist within Belgian tax law which deviate from this given principle.

3.3.2. Impact of the lex fori *on (re-)classification?*

Having resolved the issue of classification on the basis of the *lex societatis* principle, the next question regards the impact of the *lex fori*, *in casu* the law in which the investor is located who seeks to apply its domestic tax law.

More specifically and in order to arrive at a "safe harbour" in relation to foreign equity instruments when applying Belgian tax law provisions (for example in relation to redeemable preference shares issued in a common law jurisdiction in respect of the Belgian participation exemption regime), the question has been raised whether it is necessary that within Belgian company law an equivalent equity instrument exists for the given (foreign) equity instrument. And if such a demand exists, whether this means that such an equivalent instrument should share all characteristics of the foreign instrument or not?[10]

[10] For example, arts. 480 to 482 of the Belgian Company Law Code accept certain non-voting preference shares provided specific conditions are met (the purpose of these conditions is to make up for the lack of voting power): (a) the preference shares cannot amount to more than one-third of the share capital, (b) in case of profit distributions the preference shares should be entitled to a preferred dividend of which the amount is determined in advance (at the issue date) and (c) the preference shares should participate in the profit surplus on an equal basis compared to non-preference shares. As such, the given shares are preferred with respect to the repayment of capital as well as in case of liquidation. In a limited number of cases the given non-voting preference shares receive voting rights which, in general, relate to the characteristics mentioned.

From a classification perspective, it is the reporter's view that the demand for the existence of a Belgian equivalent instrument does not exist at all: if foreign non-tax law treats the instruments issued within its jurisdiction as equity, Belgian tax law should treat the instruments accordingly.

This brings us to the question of whether the same view can be upheld in the reclassification arena (see below). Again, it is the reporter's view that the application of reclassification principles should not be affected by whether or not an equivalent instrument exists under Belgian company law as long as the foreign equity instrument is correctly and rightfully classified as equity (according to its *lex societatis*) and is not open to being rightfully and correctly classified otherwise from a general (contract) or corporate law perspective (as a debt instrument) given the distinct corporate law characteristics that would have to be adhered to in such a creditor/debtor relationship (debt) and taking into account the condition that any reclassification should respect all pertinent (or necessarily relevant) legal consequences of the (equity evidencing) instrument entered into.

3.4. Reclassification and anti-avoidance

3.4.1. Introductory remarks

The Belgian tax authorities and/or the Belgian courts may reclassify transactions entered into by taxpayers on the basis of the "sham" doctrine or the Belgian general anti-avoidance provision.

3.4.2. The "sham" doctrine

As outlined above, Belgium traditionally has a "form over substance" approach. Consequently, a purely formal analysis is generally applied. On several occasions, the Belgian Supreme Court confirmed the principle of the "least taxable route" ruling that a taxpayer may take any given path to achieve an end result, even if such a route is unusual or circuitous in character as long as the taxpayer accepts and respects all the consequences of having chosen such a route. This applies even if tax saving is the only purpose of choosing such a route and even if the underlying economic reality would rather suggest another legal form yielding the same legal end result.

However, under the "sham" doctrine, the tax authorities and the courts may reclassify or ignore the apparent legal act posed by a taxpayer (because of so-called "simulation") if it can be demonstrated that the taxpayer has cancelled or altered the consequences which would ordinarily result from the legal act via a hidden or secret agreement.

Taxpayers must indeed accept all legal consequences of their planning schemes and may not cancel or alter these consequences so that the original classification of the act is no longer accurate or opposable. Simulation will thus be present if the parties involved do not accept all the legal consequences of the transaction which appear on the surface, with the "real" transaction actually aimed at by the parties thus being hidden.

The classical (and generally accepted) negative definition of simulation has been stated by the Supreme Court (*Cour de Cassation*) on 6 June 1961:

> "There is no prohibited simulation, hence no tax fraud when parties in order to get the benefit from the agreements and without violating any rule of law, consent to transactions of which they accept any and all consequences, even if the form they give to those transactions is not the most common one."

Therefore, the "sham" doctrine would in principle not apply in relation to debt, equity and hybrid financing instruments, if issuers and investors accept all the legal consequences of their financing relationship or transaction.

3.4.3. The general anti-avoidance provision

3.4.3.1. Introduction

In 1993 a "general" anti-avoidance provision was introduced to target cases where the "sham" doctrine could not be applied in the absence of a hidden agreement. This provision can be found in article 344, §1 BITC and is phrased as follows (free translation):

> "The parties cannot uphold against the competent tax authorities the legal classification which they have given to a legal act or series of legal acts realizing a single transaction, when the Belgian tax authorities ascertain through presumptions or other means of proof that this qualification is given in order to avoid direct taxes, unless the taxpayer proves that this qualification meets legitimate financial or economic needs."

According to this provision, the Belgian tax authorities may disregard the legal classification given to a legal act and reclassify for tax purposes any transaction or series of transactions entered into by the taxpayer if there are sound reasons to conclude that the parties adopted the legal classification with a view to avoiding Belgian income tax. In addition, if several legal acts constitute one single transaction, the individual legal acts may be disregarded and the legal classification of the entire transaction is potentially subject to reclassification (i.e. the "step by step" theory).

However, the taxpayer may submit counterproof to the effect that the initial legal classification adopted is supported by legitimate economic or financial needs. In such a case, reclassification is not possible. At the request of the taxpayer, the existence of legitimate economic or financial needs can be confirmed by an advance ruling from the Belgian tax authorities.

Article 344, §1 BITC has only recently been interpreted a few times by the Belgian Supreme Court.[11]

Although it is not the aim to go into too much detail, the distinction between reclassification of a single deed/contract and that of separate/consecutive acts

[11] Supreme Court, 4 November 2005; Supreme Court, 22 November 2007; Supreme Court, 10 June 2010.

should be stressed (not least because of the importance in relation to the debt–equity divide).

As far as the reclassification of a series of transactions is concerned, the text of article 344 §1 BITC – by using the term "realising" – allows itself to disregard "certain legal effects" and to refer to the "final purpose" or "end result" of the operation (regardless of the steps via which it is realised). Disregarding "certain" legal effects seems in accordance with the preparatory documents, as they indicate – by emphasising the provision's "economic perspective" – that both the tax authorities and the courts are allowed only to focus on the end result and not on the legal effects of certain intermediate steps or deeds which do not influence the (legal effects of the) end result. The fact that in such a process certain legal effects are being disregarded (or that legal effects are necessarily not identical but only "similar", even if the interposition of an entity is involved) seems irrelevant.

The preparatory documents explicitly mention that under the hypothesis of a single deed or contract, reclassification can only take place "when the given relationship is subject to more than one rightful and legally correct classification, which seems quite unlikely in practice".[12] As such, the possibility does not seem to exist of allowing the tax authorities to engage in a comparative reclassification exercise in the context of a single contract from "an economic perspective" focusing on the overall end result. This is indeed the reason why reclassification case law in respect of single deeds/contracts is much more scarce than in respect of multiple deeds, as the parliamentary documents already noted from the outset. In its 2007 case law, for example, the Supreme Court indeed confirmed that a reclassification of an act into another act is only possible if the new classification has "similar" non-fiscal legal consequences as the original act, hereby deciding that "usufruct" could not be reclassified into "rent" because of the legal differences between both legal acts.

However, in order not to render article 344 §1 BITC meaningless in practice as far as single contracts are concerned, one should be aware that the request for "identical" legal rights and obligations should be understood as focusing on the pertinent (or necessarily relevant) legal consequences and not on each and every single legal aspect involved. However, this can only serve the purpose of making article 344 §1 BITC workable. It can never mean that an "economic" interpretation replaces a "legal" interpretation: when applying article 344 §1 BITC one should always uphold the "identity" of all the pertinent legal consequences necessary to rightfully classify a transaction or deed.

In a 2010 Supreme Court case, the given principles have been further elaborated on and – although voiced in a more bold sense – were reconfirmed in a case concerning back to back directorship/management agreements between corporate entities. As a result of that case law, various remarks have been made in doctrine and in practice (also in relation to the debt–equity divide, particularly regarding profit participating instruments). After careful reflection (and as confirmed in recent ruling discussions and decisions), initial concerns were considered not well-founded.

12 Parliamentary documents no. 762-2, Senate 1992–1993, p. 37.