

THE BELGIAN NOTIONAL INTEREST DEDUCTION REGIME IN THE CONTEXT OF THE FINANCIAL CRISIS

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1. Introduction

The Belgian deduction for risk capital, also called the notional interest deduction (NID), was introduced as from financial year (FY) 2006² to *i.a.* mitigate the unjustified discrimination between debt financing (the return on which is entirely tax deductible) and equity financing (the return on which is not tax deductible). In this respect, the NID regime enables all companies with a taxable presence in Belgium³ to deduct from their taxable income a fictitious interest calculated on the basis of their equity.

In the present context of the financial crisis, commentators started to criticise the NID regime, highlighting its significant costs for the Belgian public finances, but also pointing out its limited impact on the job creation and on the development of small and medium-size companies (SMEs) in Belgium.

However, important pressure also exists in Belgium to maintain and strengthen the NID regime for tax competitiveness purposes. Indeed, the NID regime enables Belgium to remain fiscally attractive in comparison with its main neighbouring countries, knowing that the current Belgian nominal corporate tax rate of 33.99% is one of the highest in the European Union (EU). The main impact of the NID regime is to reduce this rate to an effective corporate tax rate which could be estimated at approximately 26-27%, but which could also be significantly lower,

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2 Law of 22 June 2005 introducing a tax deduction for risk capital, *Moniteur Belge/Belgisch Staatsblad*, 30 June 2005.

3 BITC, art. 205*bis* and 235, 2°.

especially for capital-intensive activities such as financing (sometimes as low as 0%)⁴.

In reaction to these critics but bearing in mind the advantages of this innovative measure, a difficult discussion has been held in the framework of the budget measures recently enacted by the Belgian government as a reaction to the financial crisis. In this respect, a political compromise has been reached to maintain the NID regime, but with certain amendments in order to limit its scope of application, *i.e.*:

- 2012 budget measures :
 - Reduction of the maximum cap applicable on the NID rate from 3.8% to 3%⁵.
 - Abolition of the possibility of carrying forward unused NID to the seven subsequent years⁶.
 - Limitation for the use of the stock of carried NID originating before FY 2012⁷.
- 2013 budget measures:
 - Abolition of the possibility to benefit from both the dividend received deduction (DRD) and NID on treasury investments⁸.
 - Introduction of the “fairness tax”⁹.

This note examines the impact of these Belgian budget measures on the NID regime and discusses its *ratio legis* in the present context of the financial crisis¹⁰.

4 A. HAELTERMAN and H. VERSTRAETE, “The Notional Interest Deduction in Belgium”, *Bull. ICFD*, 2008, n°8-9, p. 362.

5 Law of 28 December 2011 containing miscellaneous measures, *Moniteur Belge/Belgisch Staatsblad*, 30 December 2011, art. 45.

6 Law of 13 December 2012 containing tax and financial measures, *Moniteur Belge/Belgisch Staatsblad*, 20 December 2012, art. 48, 56 and 59.

7 *Ibidem*.

8 Program Law of 28 June 2013, *Moniteur Belge/Belgisch Staatsblad*, 1 July 2013, art. 4.

9 Law of 30 July 2013 containing miscellaneous measures, *Moniteur Belge/Belgisch Staatsblad*, 1 August 2013, art. 43 – 51.

10 For a more detailed analysis of the NID regime, please see A. HAELTERMAN and H. VERSTRAETE, *op. cit.*, p. 362-373.

2. Scope of application of the NID

The scope of application of the NID regime covers both Belgian entities, subject to Belgian corporate income tax, and Belgian establishment of foreign enterprises that are subject to the Belgian non-resident corporate income tax¹¹, which means that the NID regime is automatically applicable to following entities:

- Belgian companies;
- Belgian branches of foreign companies;
- Non-profit organisations (international or national) and foundations subject to Belgian corporate income tax;
- Foreign companies that own real estate located in Belgium or hold property rights in such real estate.

3. Calculation of the NID

3.1. The NID basis

The NID basis calculation starts with the net accounting equity¹² of the company as recorded in the annual accounts according to Belgian GAAP¹³ at the end of the previous financial year. This amount is then adjusted by excluding the following elements:

- In order to avoid a “cascade effect”, *i.e.* to avoid the possibility of benefiting from both the NID and the DRD regimes:
 - the net fiscal value of own shares and of fixed financial assets consisting of participations and other shares¹⁴; and
 - the net fiscal value of shares, the dividends of which qualify for the DRD regime¹⁵. Until 31 December 2012, the latter exclusion was only related to the net value of shares issued by investment

11 BITC, art. 205*bis* and 235, 2°.

12 Based on Belgian accounting law, the accounting equity of a company includes the company’s capital, share premiums, revaluation capital gains, reserves, retained earnings and capital investment subsidies.

13 For a detailed analysis of the compliance with EU law of the Belgian GAAP requirement to apply the NID regime, please see G. CRUYSMANS, “The Compatibility of the Belgian Deduction for Risk Capital Regime with EU law”, *The EC Tax Journal*, 2010, Volume 11, Issue 1, 1-41.

14 BITC, art. 205*ter*, par. 1, 2nd indent(a) and (b).

15 BITC, art. 205*ter*, par. 1, 2nd indent (b).

companies. From FY 2013, the Belgian government has, therefore, extended the scope of application of the latter exclusion to shares issued by any companies.

- In order to limit the benefits of the NID regime to equity-generating taxable income in Belgium:
 - the net accounting value of assets connected to real estate or branches that are exempt from Belgian tax by virtue of a double tax treaty¹⁶. However, this exclusion must be adapted by the Belgian government following a decision of the EU Court in the *Argenta* case¹⁷. According to this decision, the obligation to deduct the net value of the assets connected with branches established in other Member States in calculating the basis for the NID does not comply with EU law as it is a restriction of the freedom of establishment which is not proportionally justified by the preservation of coherence of the Belgian tax system or by the equal repartition of taxation power between Member States¹⁸.
- In order to avoid the benefits of the NID regime in any abusive situation¹⁹, *i.e.* to prevent companies to increase “artificially” their NID base:
 - the net accounting value of material fixed assets or part of it, as far as the related costs unreasonably exceed professional needs;
 - the net accounting value of components used as a passive investment, *i.e.* an investment which by its nature not expected to produce recurring income (*e.g.* art work, jewellery, gold,...); and
 - the net accounting value of real estate or other immovable rights used by directors, managers, liquidators, persons with similar functions within the company, but also by their spouse or children.
- In order to avoid the benefits of the NID regime for tax-exempted elements:
 - the recorded, but unrealized capital gain, the carried over tax

16 BITC, art. 205^{ter}, par. 2 and 3.

17 CJ, 4 July, 2013, C-350/11, *Argenta Spaarbank NV v Belgische Staat*, not yet published.

18 In my opinion, this reasoning is also applicable to the net accounting value of assets connected to real estate. In this respect, reference can be made to the Infringement n°2008/4335 initiated by the EU Commission.

19 BITC, art. 205^{ter}, par. 4.

credit for research & development recorded as equity capital and the capital investment subsidies²⁰.

In case of variation of the net accounting equity or of any excluded elements during the taxable period, the NID basis is finally increased or decreased on a *pro rata temporis* basis with the amount of the variation²¹.

3.2. *The NID rate*²²

The NID rate to be applied on this adjusted net equity is calculated annually on the basis of the average annual interest rate of the 10-year linear Belgian government bonds (OLO) related to the year preceding the given financial year²³. From FY 2013, the NID rate is, however, based only on the OLO rate of the third quarter (the months July, August and September) of the year preceding the given financial year, instead of the average OLO rate of 12 months.

In addition, the NID rate is subject to a maximum cap²⁴, which was originally equal to 6.5%. Subsequently, this maximum cap has been reduced by the Belgian government to 3.8% for FY 2010 and FY 2011 and then to 3% from FY 2012. However, these caps have only had an impact for FY 2010²⁵ and for FY 2012²⁶ as, except for these two years, the OLO average interest used for the calculation of the NID rate has always been lower than the caps introduced by the Belgian government.

20 BITC, art. 205*ter*, par. 5.

21 BITC, art. 205*ter*, par. 6 .

22 For the small and medium-size companies (SMEs), the applicable rates must be increased by 0.5%. See BITC, art. 205*quater*, par. 6.

23 BITC, art. 205*quater*, par. 1, 2 and 3. As from FY 2014, the OLO average interest rate of only the months of July, August and September of the year preceding the given financial year must be used to determine the NID rate.

24 BITC, art. 205*quater*, par. 5.

25 The NID rate for FY 2010 without the application of the cap at 3.8% would have amounted to (rounded) 3.9%.

26 The NID rate for FY 2012 without the application of the cap at 3% would have amounted to (rounded) 4.2%.

This is a table showing the evolution of the NID rate since FY 2006.

	NID rate
<i>FY 2006</i>	3.44%
<i>FY 2007</i>	3.78%
<i>FY 2008</i>	4.31%
<i>FY 2009</i>	4.47%
<i>FY 2010</i>	3.80%
<i>FY 2011</i>	3.43%
<i>FY 2012</i>	3.00%
<i>FY 2013</i>	2.74%
<i>FY 2014</i>	2.63%

3.3. Example

A Belgian company is financed only by equity capital used to group financing. The equity capital amount is 100,000, resulting in a NID of 2,740 (100,000 x 2.74%). The income of this company consists of an intra-group interest of 4%, resulting in a profit before tax of 4,000 EUR (100,000 x 4%).

With the application of the NID, the taxable basis is 1,260 EUR (4,000 – 2,740), resulting in a tax cost of 428.27 EUR and an effective tax rate of 10.71% as opposed to a tax cost of 1,359.60 EUR and an effective tax rate of 33.99% without the application of the NID regime .

Equity capital = 100,000.00 (used to finance a group of companies)		
Accounts	Without NID	With NID
<i>Profit before tax (intra-group interest rate of 4%)</i>	4,000.00	4,000.00
<i>NID (100,000 x 2.74%)</i>	-	(2,740.00)
<i>Taxable basis</i>	4,000.00	1,260.00
<i>Corporation tax (33.99%)</i>	1,359.60	428.27
<i>ETR</i>	33.99%	10.71%

4. Carry-forward of excess NID

4.1. General principles²⁷

Until the 31st December 2011, where there were insufficient taxable profits to fully deduct the NID of the year, it was possible to carry-forward the unused NID of the year for seven subsequent financial years (the “seven-year limitation”). From FY 2012, the Belgian government has abolished this possibility of carrying forward the excess NID, meaning that in case of insufficient taxable profits to fully use the NID of the year, the unused part of the NID is lost.

Nevertheless, the stock of excess NID available on 31 December 2011 remains deductible, but within the following limitations:

- The seven-year limitation remains applicable;
- From FY 2012, the deduction of the stock of excess NID available on the 31st December 2011 is limited to 60% of the taxable profits above 1,000,000 EUR (the “60% limitation”). The deduction of the stock of excess NID available on the 31st December 2011 which remains unused as a consequence of this 60% limitation may, however, be carried forward without any time limitation. In other words, the seven-year limitation is not applicable to the stock of excess NID available on the 31st December 2011, provided that it could have been deducted from the taxable profits if the 60% limitation had not been applicable.
- From FY 2012, the deduction of the stock of excess NID available on the 31st December 2011 became the last deduction in the computation of the taxable basis. Please find below the tax deductions available for a Belgian company to obtain its net taxable income which will be subject to tax in Belgium at the standard corporation tax rate of 33.99%²⁸ :
 1. Exemption of income derived from tax treaty countries
 2. Exemption of tax-deductible gifts
 3. Exemption of dividends that qualify for the participation exemption (“DRD”)
 4. Patent income deduction
 5. **NID of the year**
 6. Losses carried forward from previous tax years

²⁷ BITC, art. 205*quinquies* (repealed as from FY 2012) and art. 536.

²⁸ BITC, art. 207.

7. Investment deduction
8. **NID that may be carried forward (NID stock)**

4.2. Example

The taxable result of a Belgian company amounts to 2,500,000 EUR before application of any following tax deductions:

- NID of the year: 500,000 EUR;
- Losses carried forward: 500,000 EUR;
- NID stock available on 31 December 2011: 2,200,000 EUR.

The taxable basis before deduction of the NID stock is thus equal to 1,500,000 EUR, meaning that the 60% limitation will be applicable for the part of this amount exceeding 1,000,000 EUR, *i.e.* 500,000 EUR. Therefore, only 1,300,000 of the NID stock may be used to offset the tax result before deduction of the NID stock (*i.e.* 1,000,000 EUR + (60% x 500,000 EUR)), resulting in a final taxable basis of 200,000 EUR, a tax cost of 67,980 EUR (200,000 EUR x 33.99%) and an effective tax rate of 2.72%.

TAXABLE BASIS	
Taxable result before any deduction	2,500,000
<i>NID of the year</i>	-500,000
<i>Losses carried forward</i>	-500,000
Result before NID stock	1,500,000
<i>NID stock</i>	-1,300,000
Taxable basis	200,000
Corporation tax (33.99%)	67,980
ETR	2.72%
<i>Remaining NID Stock</i>	900,000 (2,200,000-1,300,000)

The remaining NID stock available on the 31st December 2011 amounts to 900,000 EUR and remains deductible with the application of the 60% limitation. However, knowing that the amount of 200,000 EUR would have been compensated by the NID stock without the application of the 60% limitation²⁹, the same amount in the

²⁹ Without the application of the 60% limitation (*i.e.* NID regime as applicable until the 31st December 2011), the tax result would have amounted to 0 EUR.

NID stock remains deductible without any time limitation. In other words, the seven-year limitation will be applicable only for an amount of 700,000 EUR.

NID stock	
700,000	Deductible with application of the seven-year limitation
200,000	Deductible without any time limitation limitation
900,000	Deductible with application of the 60% limitation

5. Introduction of the “fairness tax”³⁰

In the context of the 2013 budget measures, the Belgian government introduced the so-called “fairness tax”³¹, which is applicable from FY 2014. This tax is also an indirect way of limiting the impact of the NID regime as this special contribution of 5.15 % (*i.e.* 5% plus a 3% crisis surcharge) is applicable on the amount of distributed dividends which originate from the profit of the year and which have been compensated with the NID and the loss carried forward.

The fairness tax will, therefore, affect companies that distribute dividends out of taxable results which have not been subject to tax in Belgium due to the application of the NID regime (or to the deduction of the carried forward tax losses). In this respect, the fairness tax is an indirect way of limiting the NID regime, although both regimes have a similar objective, *i.e.* to strengthen and to favour equity-investment. Indeed, the fairness tax can be avoided easily by retaining its net income instead of distributing dividends.

6. Conclusion

First of all, it should be recalled that the NID regime was basically a replacement for the Belgian coordination centre regime which was successfully attacked by the EU Commission before the EU Court of Justice, under European state aid rules³². The purpose of this regime was to attract multinational groups to Belgium by allowing them to carry out defined auxiliary or preparatory intra-group activities

30 The purpose of this note is not to provide with a comprehensive analysis of the Belgian fairness tax regime, but to highlight the general principles of this new tax and to specify its impact on the Belgian NID regime.

31 BITC, art. 219*ter*, par. 1.

32 CJ, 9 February 2006, C-399/03, *Kingdom of Belgium (C-182/03) and Forum 187 ASBL (C-217/03) v Commission of the European Communities* [‘Belgian coordination centres’], [2006] ECR I-05479.

(especially financial, management, accounting or administrative services) through a Belgian coordination centre at a minimal tax cost. Knowing that the main activity of these coordination centres was intra-group financing and that this activity was in principle financed by using equity contributed to these coordination centres, the NID regime was therefore introduced to maintain in Belgium the activities previously allowed under the successful Belgian coordination centre regime

In the *pre-crisis* economic context, the NID regime was not only a powerful and innovative measure introduced by the Belgian government as an alternative to the Belgian coordination centre regime. The NID regime was also considered as a gift from heaven for all companies which had a taxable presence in Belgium and which were looking to reinforce their solvability by strengthening their means of financing, but also to reduce their effective income tax rates. At the time, the economy was indeed growing and the interest rates were very high, especially for SMEs for which it was very difficult to attract sufficient financing through traditional financial institutions.

However, since the economic situation has dramatically declined in recent years, the *ratio legis* of the NID regime has, therefore, been put under the spotlight in the context of the financial crisis. Indeed, the financing needs of companies and the interest rates have significantly decreased and the need to stimulate equity-financing is no longer considered such a priority. Consequently, the justification of the NID regime as a fiscal stimulus enhancing the equity of companies (in particular the SMEs) is not as relevant as in the past. However, the NID regime continues to be an indispensable measure for reducing the effective income tax rate of Belgian companies. Remaining fiscally attractive in the European area is indeed a prerequisite to revitalise the Belgian economy and to strengthen Belgium's competitiveness. In this respect, the question arises as to why not abolish the NID regime and simply reduce the current Belgian nominal corporate tax rate to a rate which is comparable to the rate of its main neighbouring countries, *i.e.* around 25% ? This solution would indeed be very easy to implement and to apply and would benefit to all companies having a taxable presence in Belgium, SMEs included.

However, in my opinion, it would be a mistake to abolish the NID regime as that would result in the transfer of the activities previously allowed under the Belgian coordination centre regime to other countries. Maintaining Belgium's attraction for multinational groups must be considered as another priority to boost investments, to create employment and to revitalise the Belgian economy. Considering this, a solution could be the introduction of a regime where the Belgian companies could opt to be subject to an income tax rate of 25% or to be subject to an income tax rate of 33,99%, combined with the application of the NID regime.

Finally, attention should also be paid to the stability of the tax legislation in Belgium. Indeed, as noted above, the scope of application of the NID regime has been limited a couple of times in recent years. By constantly amending the NID regime, the Belgian government has created confusion and legal uncertainty for investors, which is obviously not good for protecting existing investments and for attracting new investments to Belgium. Therefore, the Belgian tax system and its NID regime should be reconsidered in the context of the financial crisis, but also from a long-term perspective in order to ensure legal certainty and stability of the Belgian tax system for investors