

Notional interest deduction for risk capital and abolishment of the tax on capital contributions to Belgian companies

The law of 22 June 2005 introduces in Belgium the notional interest deduction.

Principle

As from assessment year 2007 (financial years ending on or after 31 December 2006) Belgian companies and Belgian branches of foreign companies will be able to deduct a percentage of their adjusted equity capital from their tax base. This deduction is referred to as the 'deduction for risk capital' and is considered compensation for the economic cost for using a company's equity capital at a hypothetical interest rate that reflects the cost of long-term, risk-free financing ("notional interest"). The deduction applies not only to capital increases but also to existing equity capital. The deduction is not subject to any condition of reinvestment in tangible or intangible assets or an increase in employment.

Risk capital

A company's risk capital corresponds to its equity as it appears in its nonconsolidated annual accounts of the preceding financial year. In order to avoid double counts and in order to avoid potential misuses, certain items are excluded from the definition of risk capital.

Interest rate

The deduction is computed by multiplying the company's adjusted equity capital by the interest rate applicable to ten-year government bonds (10-year OLO bonds). For assessment year 2007, the applicable interest rate is equal to the average of the monthly interest rate for ten-year Belgian government bonds for the year 2005.

The rate will be adjusted annually and will be the average rate of the year before the financial year. In principle, the new rate and the previous rate can never differ more than 1%.

The reference rate can, in principle, not exceed 6,5%.

For companies (who qualify as small- and medium-sized companies), the applicable rate is increased with 0,5% for each tax year.

Carry forward of the deduction

If a company has insufficient taxable profits for purposes of the deduction, it may be carried forward for seven years.

One condition

The laws currently states that an unavailable reserve equal to the amount of the deduction must be booked and maintained in a blocked reserve account during the taxable period and for three subsequent years. During this period, the amount of the deduction may e.g. not be distributed. If the condition is no longer met, the deducted amount will be added to the company's profits for the taxable period during which the requirement failed, and any amount that has not been deducted cannot be carried forward. After the prescribed period, the amount of the deduction can freely be distributed to its shareholders (e.g. as a tax-exempt dividend under the parent-subsiary directive).

The government recently introduced an proposition of law in order to abolish this condition in order to increase the attractiveness of the system. We expect that this proposition of law will be approved by the end of this year. Consequently, it will be able to distribute the tax savings to a foreign parent company each year.

The 0,5% capital contribution duty abolished

The Law of 22 June 2005 reduces the 0,5% capital contribution duty (currently due on any capital contribution or other increase in capital, whether on the date of the establishment or at a later date) to 0%, regardless of the amount of the contribution.

This measure will enter in force on 1 January 2006.

Example

The following example will clarify the impact of the tax measure for a intra group finance company.

Facts and circumstances

- Foreign group sets up a subsidiary in Belgium via a contribution in cash of 2,5 million EUR
- No registration duties to be paid on 2.500.000 EUR share capital
- Belgian subco lends out this cash to group companies at an interest rate of 3,75 %
- OLO of 3,25 %
- Spread of 50 bpts is an at arm's length remuneration
- Dividend qualifies for participation exemption with the parent company

Calculation

Interest received by Belgian subco (2.500.000 EUR x 3,75%)	93.750 EUR
Notional interest deduction (2.500.000 EUR x 3,25 %)	<u>(81.250) EUR</u>
Taxable base	12.500 EUR
Corporate income taxes	4.250 EUR
Effective tax burden	4,53 %

Conclusion

The notional interest deduction leads to a relevant reduction of the total corporate income tax burden. It is calculated that for many companies, taking into account average debt/equity ratios, the effect will be tantamount to a reduction of the corporate income tax rate from 33,99% to about 27% for an operating company. Depending on the financing set up, and potentially some restructuring of the financing, the effective burden may in some instances obviously be reduced below the estimated 27%. As the example above showed the tax burden could be reduced to about 5 % for an intra-group finance company.

Since the condition to reserve the tax savings for three years within the company will be abolished soon, this system is a viable alternative for many other systems of group financing companies.