ECJ Rules Belgian Participation Exemption Regime Incompatible with Parent-Subsidiary Directive

On 12 February 2009, the European Court of Justice (ECJ) issued its decision in favor of the taxpayer in the Cobelfret case, a case involving the compatibility of the Belgian dividends received deduction (DRD) regime with the EC Parent-Subsidiary Directive (Cobelfret v Belgium (C-138/07)). According to the ECJ, the DRD regime is not compatible with article 4(1) of the directive because it fails to effectively refrain from taxing dividends in some situations. The ECJ decided not to limit the temporal effects of the decision.

EC Parent-Subsidiary Directive

The EC Parent-Subsidiary Directive establishes a common system of taxation applicable to parent companies and subsidiaries of different EU Member States to prevent double taxation of dividends. According to article 4(1), when a subsidiary in one Member State distributes dividends to its parent company in another Member State, the country of the parent company must either: (1) refrain from taxing the dividends; or alternatively (2) grant a tax credit for the corporate income tax paid by the subsidiary on the underlying profits. The Member States have discretion to disallow a fixed amount of management costs related to the share participation, up to a maximum of 5% of the dividends. In addition, profits distributed by a subsidiary to its EU parent company are conditionally exempt from withholding tax.

Belgian DRD regime

In its implementation of the Parent-Subsidiary Directive, Belgium elected to refrain from taxing previously taxed profits/dividends distributed by the subsidiary (i.e. the first option). Belgium currently grants a 95% deduction for dividends on participations representing at least 10% of the subsidiary’s nominal share capital or, alternatively, participations with an acquisition value of at least EUR 1.2 million, provided the participation has been held for at least one year and it qualifies as fixed financial assets. However, because of the domestic tax rules relating to the determination of a Belgian company’s taxable base, in certain cases Belgian parent companies...
may not be effectively entitled to the DRD on dividends received.

For Belgian corporate income tax purposes, dividends received from subsidiaries are first included in the taxable base of the parent company. This dividend income is amalgamated with the net income (or loss) from other activities/operations and disallowed expenses, after which qualifying foreign permanent establishment (PE) income is exempted. It is only at this stage that a Belgian parent company can apply the DRD, i.e. deduct 95% of the qualifying dividends received from its taxable income. The deduction, however, may be used only to the extent there is taxable income remaining after the exemption of foreign PE income, i.e. it cannot lead to a negative result. Hence, the DRD can only reduce the taxable base to zero; if there is no taxable income or insufficient taxable income after the exemption of foreign PE income in a given year, any “excess” DRD is definitively lost (i.e. there is no carryforward or carryback).

Facts of the case

In 1994, 1995 and 1997, Cobelfret, a Belgian company, incurred tax losses and was unable to use the DRD. In 1996, there were insufficient profits and, therefore, Cobelfret was unable to claim the full 95% deduction on the dividends received from Belgian and U.K. subsidiaries. The company successfully challenged the Belgian DRD regime before the Court of First Instance of Antwerp as an incorrect implementation of the EC Parent-Subsidiary Directive on the grounds that the DRD did not result in Belgium refraining from taxation. Upon the appeal of the Belgian tax authorities, the Court of Appeal of Antwerp referred the case to the ECJ.

Decision of the ECJ

According to the ECJ, a taxpayer can directly rely on article 4(1) of the Parent-Subsidiary Directive, and Belgium failed to implement the directive correctly because it does not effectively refrain from taxing dividend income in all situations.

In fact, the Belgian rules subject the DRD to an additional condition that is not provided for in the directive. As a result, dividends received from a subsidiary are always included in a parent company’s basis of assessment, but cannot always be deducted since a deduction is disallowed if the parent has no or insufficient taxable profits for the relevant period. The fact that the application of the credit method (i.e. the alternative method allowed under the directive) can lead to the same result as the DRD regime is irrelevant according to the ECJ, because Belgium elected not to use the credit method to prevent the double taxation of dividends.

In accordance with the ECJ’s established case law, the Court’s interpretation of Community law is limited to clarifying and defining the meaning and scope of a rule as from the time it came into force. Consequently, ECJ decisions generally take effect ex tunc, implying for practical purposes that decisions are valid for situations that arose before the decision was issued. Following the opinion of AG Sharpston in Cobelfret, the ECJ has refused to limit the temporal effect of its
decision. As a result, Belgian courts must also apply this decision to dividend payments that were made in the past.

Comments

It should be noted that three other Belgian cases are pending before the ECJ challenging the same set of rules (KBC Bank NV (C-438/07), SA Beleggen, Riscokapitaal, Beheer (C-499/07) and Atenor Group (C-514/08)). The first case raises additional questions, including: (1) whether the freedom of establishment principle of the EC Treaty requires that qualifying dividends be completely exempt from Belgian taxation in the same way as profits of foreign PEs; and (2) whether the free movement of capital principle prohibits dividends received from subsidiaries resident in third countries from being treated less favorably than domestic Belgian or EU dividends.

The ECJ’s statement that EU Member States cannot impose additional conditions not provided for in the Parent-Subsidiary Directive jeopardizes Belgium’s requirement regarding the relevant participation qualifying as a fixed financial asset (Belgium introduced this condition effective, in principle, from tax year 2004 (i.e. financial years ending on 31 December 2003 or later)).

Companies should review all DRD that was lost in whole or in part potentially to 1992 (i.e. the year the Parent-Subsidiary Directive came into effect) as a result of an insufficient tax base. Further, it should be noted that the impact of the decision may extend to deferred tax positions.