

Newsflash

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Tax Law

AG Sharpston declares Belgian DRD incompatible with EC Parent-Subsidiary Directive

On 8 May 2008, Advocate General (AG) Sharpston issued her opinion in the *Cobelfret v Belgium* case (Case C-138/07) regarding the compatibility of the Belgian dividends received deduction regime (DRD) with the EC Parent-Subsidiary Directive. According to AG Sharpston, the Belgian DRD regime is not compatible with article 4(1) of the Directive.

AG Sharpston also recommends that the European Court of Justice (ECJ) rejects the Belgian government's request to limit the temporal effects of the decision in favour of the taxpayer.

1. The Parent-Subsidiary Directive

The Parent-Subsidiary Directive establishes a common system of taxation applicable for parent companies and subsidiaries of different EU Member States to prevent double taxation of dividends. In its implementation of this Directive, Belgium chose to refrain from taxing previously taxed profits/dividends distributed by the subsidiary (i.e. the first option that the Directive offers). This mechanism is called the 'Dividend Received Deduction' regime (DRD). By means of a deduction of the taxable income, dividends received by the parent company are to be exempt from corporate income tax. The DRD does not distinguish between Belgian, EU or non-EU dividends.

However, if, in a given year, insufficient or no taxable income is available to offset the dividends received by the parent company, double taxation arises as the DRD mechanism does not allow for a carry forward of the "excess" dividends received by that parent company. Any "excess" is definitively lost.

2. Facts of the Cobelfret 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 deduction on the dividends received from Belgian and U.K. subsidiaries.



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The company successfully challenged the Belgian DRD before the Antwerp Court of first instance as an incorrect implementation of the Parent-Subsidiary Directive on the grounds that the Belgian DRD did not result in refraining from applying (double) taxation of dividends received by the parent company. Upon appeal by the Belgian tax authorities, the Antwerp Court of Appeal referred the case to the ECJ. The European Commission also fully supported the position of the company.

3. Opinion of AG Sharpston

AG Sharpston agreed with the taxpayer and the European Commission on all accounts. According to AG Sharpston, a taxpayer can rely directly on article 4(1) of the Directive and Belgium failed to implement the Directive correctly because it does not effectively refrain from taxing dividend income in all situations.

In fact, according to the Belgian rules, the deduction is subject to an additional condition that is not provided for in the Directive. According to AG Sharpston, the effect of the Belgian DRD regime is that, while dividends received from a subsidiary are always included in the parent company's basis of assessment, they cannot always be deducted since a deduction is forbidden if the parent has insufficient or no taxable profits for the relevant period. This ultimately gives rise to a higher tax because it will reduce the amount of the loss that may be carried forward. Moreover, according to AG Sharpston, 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 since Belgium chose not to use the credit method to prevent the double taxation of dividends.

AG Sharpston also opines that, even if domestic and cross-border situations are treated equally, Belgium's current DRD mechanism cannot in itself render the transposition of the Directive correctly. Finally, AG Sharpston advises the ECJ not to limit the temporal effects of a decision that favours the taxpayer because Belgium failed to demonstrate that there is a risk of serious economic repercussions.

4. Preliminary Comments

- a. Although the ECJ still needs to rule on the case, AG's Sharpston's opinion is excellent news for Belgian taxpayers with excess DRD, since the ECJ generally follows the opinion of the AG.

It should be noted that two other Belgian cases are pending before the ECJ (C-439/07 – KBC and C-499/07 Beleggen Risicobeheer Kapitaal). They challenge the same set of rules and one of them is litigated by Laga.

The first case raises additional questions, including: (1) whether the freedom of establishment principle of the EC Treaty requires that qualifying dividends be completely (i.e. 100% instead of 95%) exempt from Belgian taxation in the same way as profits of foreign permanent establishments; and (2) whether the free movement of capital principle prohibits dividends received from subsidiaries that reside in third countries from being treated less favourably than domestic Belgian or EU dividends.

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- b. AG Sharpston's opinion that EU Member States must not apply additional conditions that are not provided for in the Directive jeopardizes Belgium's requirement regarding the relevant participation qualifying as a financial fixed asset. Belgium rendered this condition effective, in principle, from tax year 2004 (i.e. financial years ending on 31 December 2003 or later).
- c. For Belgian corporate taxpayers that have already filed (protective) claims or initiated (protective) legal proceedings, AG Sharpston's opinion substantially increases the likelihood of a positive outcome.

Potentially affected taxpayers that have not yet taken appropriate action are urgently advised to consider doing so, especially if the ECJ would impose a limitation on the effects of the ruling.

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