THE ECJ DECISION IN *ARGENTA*: BALANCED ALLOCATION OF TAXING POWERS AND BELGIAN NOTIONAL INTEREST DEDUCTIONS

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In *Argenta Spaarbank NV v Belgische Staat* (C-350/11), the European Court of Justice (ECJ) determined that the Belgian deduction for risk capital, also known as the "notional interest deduction" (NID), was incompatible with the freedom of establishment under EU law.

According to the Court, this regime treated resident companies having a permanent establishment (PE) situated in another Member State less favourably than resident companies with a PE in Belgium, in situations where the profits of the foreign PE are not taxable in Belgium by virtue of a double tax convention (DTC). The Court also decided that this restriction was not capable of being justified by any overriding reasons in the public interest.

This judgment raises an important question related to the scope of the justification of the balanced allocation of the taxing powers of the Member States, which appears to have been narrowed by the Court in this case. However, it will be argued that *Argenta* is in line with the previous case law of the Court.

Background

Introduced in 2005, the notional interest deduction allows companies subject to full tax liability in Belgium to claim tax relief for a hypothetical amount of interest,

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calculated as a percentage of their equity capital, when establishing the basis of assessment for corporate tax.

The aim of these Belgian provisions is to create a fiction that puts companies that raise money through equity capital in the same situation as companies that finance themselves through debt, since, only the return on the latter is usually entirely deductible. For tax purposes, a company is therefore treated as if it had borrowed some of its subscribed capital at a specific rate and this notional interest is deducted each year from the taxable income of the company.

Although this appears to be the main objective mentioned in the legislative preparatory work, it has generally been assumed that the NID regime was mostly meant to constitute an "EU-proof" alternative to a regime previously considered by the ECJ as a State aid, namely the Belgian Coordination Centre regime[2]. Thus, it is believed that the NID regime was primarily intended to keep these coordination centres in Belgium by giving a new tax relief to these companies acting as "intra-group" banks by being involved in cash-pooling operations of their group and therefore having a high level of assets.

The NID deduction is equivalent to the company's "risk capital" multiplied by a rate based on the annual average of the monthly published interest rates for 10-year linear Belgian government bonds over the year before the financial year concerned.

The risk capital to be taken into account corresponds to the taxpayer's equity capital reduced by the net value of certain assets, which are tax-exempt under Belgian tax law or under a tax treaty.

The adjustment at issue in the *Argenta* case was the net value of the assets of PEs situated in another Member State and the income from which was exempt under a DTC. *Argenta Spaarbank NV* is a company resident in Belgium with a Dutch PE that was refused the granting of the NID in proportion to the net assets of its PE as the profits derived from the Dutch PE were not taxable in Belgium according to the DTC concluded between Belgium and the Netherlands. Accordingly, the Antwerp Court of First Instance submitted a question under the preliminary ruling to the ECJ, asking whether the NID regime violated EU law.

2 ECJ, 22 June 2006, C-182/03 and C-217/03, *Kingdom of Belgium and Forum 187 ASBL v Commission of the European Communities ("Belgium v Commission"),* [2006] ECR I-5584.

Freedom of establishment

The Court determined that the fundamental freedom at stake in this case was the freedom of establishment. The Court recalled that it follows from art 49 TFEU and 54 TFEU that the freedom of establishment includes the right of companies established in a Member State to carry on business in another Member State through a subsidiary, a branch or an agency and, that restrictions on this freedom by the Member State of origin are prohibited unless justified. This also applies where the activities are pursued through a PE.[3]

Restriction

The NID regime clearly establishes a difference in treatment between the assets of Belgian resident companies with PEs situated in Belgium and the assets of Belgian resident companies with PEs situated in another Member State, the income from which is not taxable in Belgium. In the latter situation, the assets of the non-Belgian PE are not taken into account when identifying the risk capital of the taxpayer serving as a basis for computing the NID deduction[4]. The Court highlighted that taking account of the assets of a PE undoubtedly constitutes a tax advantage for the Belgian company, since it helps to reduce the effective rate of the corporation tax payable in Belgium[5]. Such a tax advantage is denied when a company exercised its freedom of establishment through a PE situated in a Member State with which Belgium has concluded a DTC which includes an exemption for the profits attributed to the PE[6].

The Belgian government argued that the difference in treatment was not a restriction on the freedom of establishment since, even if the assets of that PE were taken into account, the profits of the resident company could not be reduced because the deduction would have been applied first to the profits made by that establishment[7]. However, any surplus would still be deducted from the profits made by the resident company. Therefore, the Court decided that "it does not follow from this argument that it would be impossible for the resident company to

3 ECJ, 4 July 2013, C-350/11, *Argenta Spaarbank NV v Belgische Staat ("Argenta"),* para. 18-21 (not yet reported).

4 *Argenta*, para. 22-23.

5 *Argenta*, para. 24.

6 *Argenta*, para. 25.

7 *Argenta*, para. 27.

benefit, for the purpose of reducing its basis of assessment, from the deduction for risk capital calculated by taking account of the assets of the foreign PE"[8].

The Belgian government also claimed that the restriction was the result of the fact that the Member State in which the PE was situated did not provide for any deduction for risk capital. However, the Court ruled that it stemmed solely from the choice made in the Belgian legislation to treat companies differently depending on the location of their PE and not from the exercise in parallel by two Member States of their fiscal sovereignty[9]. As a result, that tax advantage was not a disparity caused by the interaction between the legislation of Belgium and the Netherlands.

Therefore, *Argenta* was correct that the limitation to the NID in this situation was disadvantageous and that such treatment was liable to deter a Belgian company from carrying on its business through a PE situated in another Member State and therefore constituted a restriction prohibited by the Treaty[10].

Justifications

The Belgian government put forward three arguments to justify the restrictive nature of its legislation: the need to ensure the coherence of its tax system, the need to ensure the balanced allocation of taxing rights between the Member States and the need to provide for a parallel treatment between debt funding and equity funding of Belgian companies. However, each of these justifications was rejected by the Court.

Invoking the need to safeguard the coherence of the Belgian tax system, the government first argued that the NID regime was "perfectly symmetrical and that a direct, personal and material link [existed] between the tax advantage, which is calculated by reference to assets, and the taxation of the profits generated by those assets"[11]. To support this argument, the government compared that link with the one existing between deductible interest on a loan for acquiring an asset and the taxable profit generated by that asset[12].

8 *Argenta*, para. 30.

9 *Argenta*, para. 33.

10 *Argenta*, para. 34.

11 *Argenta*, para. 37.

12 *Argenta*, para. 38.

Citing *Bachmann* (C-204/90), *Manninen* (C-319/02), *Keller Holding* (C-471/04) and *Papillon* (C-418/07), the Court indicated that the need to maintain the coherence of a tax system could constitute an overriding reason of public interest justifying a restriction on freedom of establishment[13]. However, in line with its traditional reasoning, the Court ruled that, although the advantage was granted only where the profits generated by the PE were taxable in Belgium, there was no direct link between the tax advantage (the taking into account of the assets of a PE) and the offsetting of that advantage by a particular tax levy (taxation of the return generated by the assets)[14]. Indeed, the Court pointed out that "the legislation at issue requires solely that any income generated by that PE be tax*able* in Belgium, without making grant of the advantage in question conditional on such income actually being generated or actually being tax*ed*"[15]. Thus, for instance, if that PE has not generated any income, its assets would still be taken into account for NID purposes. Going a step further, the income tax code even allowed for the carry forward of the deduction on future profits[16].

Furthermore, as noted by Advocate General Mengozzi, "the fiscal coherence relied on by the Kingdom of Belgium seems to have been shifted to the level of the reciprocity of the applicable rules of the Belgium-Netherlands Convention"[17]. Since the *Wielockx* decision, the objective of fiscal coherence may not be invoked to justify the refusal of a tax advantage when cohesion of the tax system is secured by a bilateral convention concluded with another Member State[18]. Indeed, even though Belgium waived the right to tax the profits of Dutch PEs of Belgian companies, conversely, Belgium was entitled to tax the profits of Belgian PEs of Dutch companies. Thus, coherence of the tax system did not in this case occur at the level of the individual taxpayer but could be achieved at the level of the DTC concluded between Belgium and the Netherlands. Accordingly, the Court rejected this justification.

Secondly, the Belgian government relied on the need to preserve the balanced allocation of taxing rights between the Member States and argued that Belgium was "exercising its power of taxation in compliance with the principle of

13 *Argenta*, para. 41.

14 *Argenta*, para. 42-46.

15 *Argenta*, para. 47.

16 *Argenta*, para. 48.

17 ECJ, 4 July 2013, C-350/11, *Argenta Spaarbank NV v Belgische Staat ("Argenta")*, Opinion of AG Mengozzi, para. 57 (not yet reported).

18 ECJ, 11 Aug. 1995, C-80/94, *G. H. E. J. Wielockx v Inspecteur der Directe Belastingen ("Wielockx")*, [1995] ECR I-02493, para. 25.

territoriality and in accordance with the allocation of the power to tax as resulting from the Belgium-Netherlands Convention"[19].

In reply, referring to *Marks & Spencer* (C-446/03) and *Rewe Zentralfinanz* (C-347/04), the Court first, recalled that the fact that a Member State has agreed in a DTC that the profits attributable to a PE are taxable only in the host Member State cannot systematically lead to the denial of a tax benefit to the company the PE belongs to by the Member State of residence. In line with its settled case law, the Court held that otherwise it would mean that the mere existence of a cross-border economic activity would be capable of justifying any difference of treatment caused by the denial of a tax advantage.[20]

The Court has recognised this objective as an overriding reason of public interest since its *Marks & Spencer* judgement. The analysis of ECJ cases subsequent to *Marks & Spencer* shows however that, to be accepted by the Court, this justification always needs to be backed up by other concerns, such as the risk of tax avoidance, the risk of double-dipping in the context of cross-border losses, etc. (*Oy AA* (C-231/05), *Amurta* (C-379/05), *Aberdeen Property* (C-303/07), *Commission v Germany* (C-284/09), *Santander* (C-338/11 to C-347/11)). In other words, some threat or jeopardy to the balanced allocation must be demonstrated by the tax authorities.

That point is crucial in *Argenta*, where the Court emphasised once again the requirement of a "manipulative behaviour of the taxpayer", to quote Luc De Broe's words[21]. Indeed, the preservation of the balanced allocation between the Member States' right to tax should solely be accepted by the Court where the provisions at issue are "designed to prevent conduct capable of *jeopardising* the right of a Member State to exercise its power of taxation in relation to activities carried out in its territory"[22]. Thus a clear threat to the balanced allocation of taxing powers must be demonstrated.

The Court refers to its cross-border loss jurisprudence in paragraph 54 of *Argenta*, noting that the objective of the preservation of the balanced allocation of taxing powers "is designed inter alia to safeguard symmetry between the right to tax profits and the entitlement to deduct losses of a PE, inasmuch as acceptance that

19 *Argenta*, para. 39-40.

20 *Argenta*, para. 51-52.

21 Luc De Broe, "The ECJ's judgment in Argenta: Narrow interpretation of 'the preservation of the balanced allocation of taxing rights between Member States'. A headache for designers of tax incentives in the Union" (2013) EC Tax Review, 5, p. 212.

22 *Argenta*, para. 53.

the losses of a non-resident PE might be deducted from the income of the principal company would result in allowing that company to choose freely the Member State in which it claims such losses".

In *Marks and Spencer*, the Court held that this objective could indeed "make it necessary to apply to the economic activities of companies established in one of (the) Member States only the tax rules of that State in respect of both profits and losses"[23].

In the same way, in the case at issue, Belgium wanted to apply its national rules in respect of both the foreign assets (denial of the NID) and the profits derived from these assets (not part of the corporation tax base in Belgium).

The necessity of maintaining this symmetry in *Marks & Spencer* and other cross-border loss cases was justified, however, because there was a risk of manipulation by the taxpayer translated, for instance, into the risk of double-dipping, loss trafficking or tax avoidance[24].

In *Lidl Belgium* (para. 38-42), the Court discussed the question of whether the different justifications set out in the judgement in *Marks & Spencer* (the need to preserve the balanced allocation of taxing powers, the risk of double-dipping and the risk of tax avoidance) must be understood as being cumulative[25]. Indeed, the Court at that time held that the three justifications *taken together* pursued legitimate objectives compatible with the Treaty and thus constituted overriding reasons in the public interest. Referring to *Oy AA*, the Court answered negatively, highlighting the "wide variety of situations in which a Member State may put forward such reasons"[26]. However, in *Oy AA*[27] as well as in *Lidl Belgium*[28], the Court concluded in favour of the government on grounds of two of these factors; not just one.

23 ECJ, 13 Dec. 2005, C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* ("*Marks and Spencer*"), [2005] ECR I-10837, para. 45.

24 Tom O'Shea, *EU Tax Law and Double Tax Conventions*, Avoir Fiscal Limited, 2008, p. 137.

25 ECJ, 15 May 2008, C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* ("*Lidl Belgium*"), [2008] ECR I-03601, para. 38.

26 *Lidl Belgium*, para. 40.

27 ECJ, 18 July 2007, C-231/05, *Oy AA*, [2007] ECR I-6373, para. 60.

28 *Lidl Belgium*, para. 41-42.

Thus, it seems clear that the exact same circumstances as the ones in *Marks & Spencer* do not need to be met in order for the Court to validate a restriction on grounds of the need to preserve the balanced allocation of taxing powers. However, it is "not sufficient for the Member States to put forward the "symmetry" argument and rely on that argument alone as jeopardising the balance in the allocation of taxing rights between the Member States; there [has] to be something more"[29].

Regarding cross-border loss relief, it is quite clear how a taxpayer may jeopardise the balanced allocation of the taxing rights of the Member States by using twice the same losses or by moving the losses to the Member State where the value of the losses is the highest. The symmetry threatened thereby is also quite obvious: "profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system"[30].

In its decision in *Argenta*, however, the Court came to the conclusion that "excluding exempt PE assets for purposes of the NID computation [did] not come within the scope of this justification"[31]. Particularly, taking account of a foreign PE assets in the calculation of the NID would jeopardise neither Belgium's, nor the Netherlands' power to tax in relation to activities carried out in their territory and would not result in the shifting of income normally taxable in one of those Member States to the other[32]. As a result, there was no symmetry to maintain in the present case. The ECJ explained that it did not see any symmetry in the purpose of the restrictive provisions, as it underlined regarding the justification based on the cohesion of the tax system.

As pointed out by Barry Larking, "it certainly seems correct that it would not result in a shifting of income between Belgium and the Netherlands: the Belgian taxable profits are admittedly reduced, but there is no increase in the Dutch taxable profits"[33]. This is due to the fact that, unlike a loss relief provided for by many jurisdictions, the deduction of these hypothetical interests is peculiar to Belgium; the Netherlands do not provide for the fiscal deduction at stake.

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29 Tom O'Shea, *loc. cit.*, p. 137. O'Shea highlights *Marks & Spencer* para. 40, where the Court rejected the "two sides of the same coin" argument.

30 *Marks & Spencer*, para. 43.

31 Barry Larking, "A plea for EU legal certainty" (2013) Tax Notes International, September 23, p. 1197.

32 *Argenta*, para. 55.

33 Barry Larking, *op. cit.*, p. 1198.

"However, this does not answer the question why including exempt PE assets in the NID computation does not jeopardise Belgium's power to tax profits regarding activities carried out in Belgium. If 'activities carried out' is replaced by 'assets located in', it seems clear that the profits generated by Belgian assets will be reduced if account has to be taken of non-Belgian assets. It seems unlikely that there could be a relevant difference between activities and assets in this context."[34]

Therefore, as to the question posed by Luc De Broe: why was there no symmetry to maintain by denying a tax relief regarding assets invested in a foreign PE in relation to which Belgium has no tax jurisdiction?[35] It is presumably due to the fact that there was no evidence of possible "manipulative conduct" of the part of the taxpayer, likely to erode Belgium's tax base. In other words, the existence of a second factor that led the Court to accept this justification in cases such as *Oy AA* and *Lidl Belgium* was missing here.

In Luc De Broe's opinion, the ECJ's decision on this point is debatable because being able to reduce the Belgian tax base by means of the NID would definitely affect taxpayer's behaviour[36]. As a result, the second factor underlying the success of this justification in previous cases and reflecting the taxpayer's behaviour requirement was present in *Argenta*, namely the risk "for Belgian companies to allocate assets to PE's in low tax Member States and claim the extra NID against Belgian profit"[37].

The Belgian government should have come up with this element in order to support its argument based on the need to preserve the balanced allocation of taxing rights between Member States. Nevertheless, regarding the logical symmetry required, the fact that the profits were required to be tax*able* and not actually tax*ed* according to the Belgian provisions[38] would probably have remained an issue.

It should however be mentioned that, since the facts of the case, the possibility of carrying forward the unused NID for seven subsequent years was abolished from the tax year 2013 onwards, making the symmetry at issue much more logical. Therefore, one may ask the question whether the current NID is still an unjustified restriction on the freedom of establishment under EU law.

34 Barry Larking, *op. cit.*, p. 1198.

35 Luc De Broe, *op. cit.*, p. 211.

36 Luc De Broe, *op. cit.*, p. 212.

37 *Ibid.*, p. 212.

38 *Argenta*, para. 47.

The Court also refused to accept the argument of the Belgian government regarding the parallel treatment that Belgium was trying to establish between loans taken out by a resident company to acquire assets attributable to a PE and equity capital attributed to the PE also in order to acquire assets. The idea underlying this last argument was that, "in both instances, the cost of funding is to be borne by the PE-State"[39].

The ECJ rejected the analogy between these two types of deductions, contrasting the way they are computed: the deduction for interest was calculated "as a proportion of the taxable profits generated by the company's assets"[40], whereas "the NID is computed in a lump-sum manner as a percentage of the company's equity and bears no relation to the taxable profit generated by the company"[41].

The Court in this part of the case is quite nebulous. Indeed, deduction of interest on loans is also neither conditional on the existence of profits, nor proportionate to its amount[42]. That difference may not be as relevant as the Court seems to state.

Conclusion

To sum up, the denial of the NID in respect of PEs' assets located in other Member States (all of which Belgium has concluded a DTC with) was declared to be an unjustifiable breach of the freedom of establishment by the ECJ. The Court's reasoning in respect of the argument of the coherence of the tax system could be expected and therefore has not been called into question in the literature. However, the situation was different as regards the need to preserve the balanced allocation of the taxing powers between the Member States, which triggered some debates among scholars. This article demonstrated that the conditions required to validate this justification have not been restricted by the Court, since the reasoning in *Argenta* was in line with its previous jurisprudence. The two conditions to be highlighted in this context are the taxpayer's manipulative behaviour requirement and the existence of a logical symmetry to maintain in relation with the likelihood of the manipulation in question.

Regarding this second justification, the removal of the possibility of carrying forward a stock of notional interest adds a new element to this debate. Indeed, it

39 Luc De Broe, *op. cit.*, p. 211.

40 *Argenta*, para. 56.

41 Luc De Broe, *op. cit.*, p. 211.

42 *Ibid.*, p. 211; Barry Larking, *op. cit.*, p. 1199.

might well make the restrictive nature of the NID justified, provided for a clear threat to the balanced allocation of the taxing powers of the Member States to be demonstrated. As suggested by Luc De Broe, this threat would be the risk for Belgian companies to allocate assets to PE's in low tax Member States and claim the extra NID against Belgian profits.