BRUSSELS SECURITIES: BELGIAN DEDUCTION MECHANISM BREACHED PARENT-SUBSIDIARY DIRECTIVE

Dr Tom O'Shea[1]

In a follow-up to the Court's earlier judgments in *Cobelfret* [2] and *Argenta Spaarbank,*[3] the Court of Justice delivered another significant judgment in relation to Belgium's deduction regime for corporate income tax purposes in *Brussels Securities SA v État Belge ("Brussels Securities").*[4] The Court determined that the Belgian rules at issue breached Article 4(1) of Directive 90/435 EEC (the "Parent-Subsidiary Directive").

Part I

Background

The problem in this case arose because of Belgian rules which prescribed a particular order for the deduction of deductible income from taxable profits. This resulted in a loss of certain tax advantages in some instances.

Brussels Securities argued that such rules were incompatible with the Parent Subsidiary Directive, Article 4(1). When Belgium implemented the Parent Subsidiary Directive, it opted for the exemption system set out in Article 4(1) of the Parent Subsidiary Directive. This meant that it had to refrain from taxing the profits of the parent company insofar as they were received from its subsidiary, provided certain conditions were complied with.

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1 Dr Tom O'Shea is the Director of the Academy of European and International Taxation, London. He may be contacted at tom@drtomoshea.com. Comments on this article are welcome.

2 *Belgische Staat v Cobelfret NV ("Cobelfret"),* C-138/07, ECLI:EU:C:2009:82.

3 *Argenta Spaarbank NV v Belgische Staat ("Argenta Spaarbank 2"),* C-459/18, ECLI:EU:C:2019:871.

4 *Brussels Securities SA v État Belge ("Brussels Securities"),* C-389/18,

Belgian Law

The Belgian rules provided that 95% of the dividends received by a Belgian parent company from its foreign subsidiary (that complied with the necessary conditions) were deductible from its profits under the system for taxing income ("definitively taxed income" or "DTI"). If such dividends could not be deducted, they could be carried forward to be used in future tax years.

Another rule provided for a deduction for risk capital (DRC). In tax years when there were no profits (or if profits were insufficient) in order for the DRC to be granted, the Belgian rules provided that any DRC relief not granted could be carried forward to be used against profits of the next seven tax periods. The rules provided that DRC deductions were deducted after DTI deductions.

The Problem

The Belgian tax authorities insisted that the correct order of deductions and carry forward of unrelieved deductions was first, deduct under the DTI system; then, deduct DRC and afterwards, carry forward any losses. This mechanism resulted in companies that applied the DTI system losing the benefits of the DRC tax advantage up to the amount that they could deduct under the DTI system. Consequently, a company like Brussels Securities suffered a heavier tax burden because the dividends it received from its subsidiary were included in the company's tax base and subsequently, 95% were excluded. The Court explained the problem, in paragraphs 42 and 43 of *Argenta Spaarbank 2*, where it noted that -

> "the deduction as a priority of DTI may reduce or even extinguish, the tax base, which may have the effect of depriving the taxpayer, totally or partially, of another tax advantage …
>
> while … losses may be carried forward indefinitely, DRC may be carried forward only to the following seven tax years. In those circumstances, the order in which deductions must be applied … may result in the expiry of the right to use the deferred DRC, up to the amount of DTI that has been deducted as a priority from the parent company's taxable profits".

The Court concluded, in paragraph 45, that –

> "It is therefore apparent that the combination of the DTI scheme applicable to dividends received, the order of deductions set out in national legislation, and the time limit on the ability to use DRC can have the effect that receiving dividends is likely to result in the parent company losing another tax advantage provided for by national legislation, and, therefore, that company being taxed more heavily than would have been the case if it had not received dividends from its non-resident subsidiary or if, as the referring court states, the dividends had simply been excluded from the parent company's tax base".

The Court indicated that such tax treatment amounted to a breach of Article 4(1) of the Parent Subsidiary Directive.

Justification

The Court rejected the submission that the order in which the deductions are dealt with was not covered by the Article 4(1) of the Parent Subsidiary Directive. In paragraph 48, the Court stated that –

> "in the absence of EU level harmonisation measures, it is for the Member States to determine both the order in which deductions may be applied to the tax base of a parent company and the time limits for carrying forward such advantages. However, that power must be exercised in compliance with EU law".

The Court explained that Belgium chose to adopt the exemption method when it implemented the Parent Subsidiary Directive. In implementing that scheme, Belgium chose to include the dividends received in the parent company's tax base and subsequently, to deduct those dividends from the tax base. It also provided for the possibility of carrying forward DTI to future years with a view to any surplus being deducted as a priority. Accordingly, the Belgian scheme triggered a possible interaction between dividends and other elements of the tax base, such as the DRC.

The Court went on to explain, in paragraph 49, that –

> "In those circumstances, the effects of that interaction must comply with Directive 90/435, irrespective of the fact that establishing the order in which tax deductions are to be applied and the time limit for carrying forward the DRC are solely a matter of national competence".

The Court highlighted, in paragraph 51, that –

> "although the harmful effects of national legislation such as that at issue in the main proceedings are likely to occur only in certain situations and not systematically, the fact remains that such legislation has effects which are incompatible with Directive 90/435".

The Court also determined that the parent company could not be taxed indirectly on the dividends, through the loss of a tax advantage such as DRC, which indirectly imposed a heavier tax burden on the parent company that received the cross-border dividends.

The Court's Conclusion

The Court concluded that Article 4(1) of Directive 90/435 must be interpreted as precluding legislation of a Member State which provides that dividends received by a parent company from its subsidiary must first be included in the tax base of the parent company before 95% of the amount of the dividends is then deducted, and any surplus may be carried forward to subsequent tax years indefinitely, that deduction having priority over another tax deduction which may only be carried forward for a limited time.

Part II

Analysis

The judgment of the Court in *Brussels Securities* demonstrates the supremacy of EU law in relation to national rules that fail to comply with an EU directive, in this case the Parent Subsidiary Directive.

When Belgium implemented the Parent Subsidiary Directive into national law, it chose to apply the exemption method option set out in Article 4(1) of the Directive. This meant that it agreed to exempt cross-border dividends that met the conditions for the application of the Directive from taxation in Belgium, to the extent required by the Directive, that is at least 95% of the dividends received.

The Belgian regime, that implemented this exemption scheme, involved including in taxable income all the dividend income so received from the cross-border subsidiary and allowing 95% of that income to be deducted from taxable income. The rules provided for a carry-forward of any surplus deductions to future years in so far as it was not possible to deduct them from the taxable income (so-called DTI relief). This created a problem because this deduction mechanism interacted with another deduction relief – DRC. [The DRC rules featured in the *Argenta Spaarbank* cases[5] of the Court].

The Belgian rules provided that DTI deductions had to be made prior to DRC deductions. DRC deductions could be carried forward to future years if they were unused but this relief was limited to seven years, whereas deductions under DTI could be carried forward indefinitely. Consequently, since DTI deductions had to be used first, there was a possibility that DRC reliefs would be lost in the process. Losing such

5 See *Argenta Spaarbank NV v Belgische Staat ("Argenta Spaarbank I"),* C-350/11, ECLI:EU:C:2013:447 and *Argenta Spaarbank NV v Belgische Staat ("Argenta Spaarbank 2"),* C-459/18, ECLI:EU:C:2019:871. For analysis, see Tom O'Shea, "Belgian Notional Interest Deduction Rules Challenged Before the ECJ", Tax Notes International, Mar. 10, 2014, 915-919 and Tom O'Shea, *Argenta Spaarbank 2: Deduction Rules for Risk Capital Challenged Again*, ECTJ, 18, Jan. 2020, 87- 95.

a tax advantage meant that companies suffered a higher tax burden because they were denied a DRC deduction.

The Scope of Article 4 of the Parent Subsidiary Directive

The Court explained in paragraph 33 of *Brussels Securities*, that –

> "the obligation on a Member State which has chosen the system set out in the first indent of Article 4(1) of Directive 90/435 to refrain from taxing the profits of the parent company which it receives by virtue of its association with its subsidiary is not subordinated to any condition and is expressly subject only to Articles 4(2) and (3) and 1(2) of that directive".

Therefore, Member States had to follow the rules set out in Article 4 of the Parent Subsidiary Directive and not add any new conditions when implementing or applying that Directive.

The Court indicated, in paragraphs 36 and 37, that the Directive aims –

> "to avoid taxation of distributed profits, first, in the hands of the subsidiary and, then, in the hands of the parent company …
>
> and that that prohibition also applies to national legislation which, although it does not tax the dividends received by the parent company in themselves, may have the effect that the parent company is subject indirectly to taxation on those dividends".

The Court highlighted, in paragraph 42, that the Belgian rules which required DTI deductions to be given priority –

> "may reduce or even extinguish, the tax base, which may have the effect of depriving the taxpayer, totally or partially, of another tax advantage".

The Court also noted that the Belgian rules could result in the expiry of DRC reliefs after the designated seven-year period, resulting in the parent company incurring a heavier tax burden through the loss of the DRC tax advantage. The Court held that, in such circumstances, the objective of Article 4(1) of the Directive would not be achieved.

Compliance with EU Law

While the Court accepted that it was a matter for the Member States to determine the order of deductions from taxable income, it quickly reminded them that, in the absence of harmonised rules, such an exercise of a State's taxing powers was subject to compliance with EU law, in particular, in this case, with Article 4(1) of the Directive.

In implementing the Parent Subsidiary Directive, Belgium opted for the exemption method contained in Article 4(1) of that Directive. Accordingly, it was the Belgian rules that created the interaction between dividends and other elements of the Belgian tax base, such as the DRC relief regime.

The Court pointed out, in paragraph 49, that –

> "the effects of that interaction must comply with Directive 90/435, irrespective of the fact that establishing the order in which tax deductions are to be applied and the time limit for carrying forward the DRC are solely a matter of national competence".

The Court concluded that these effects, even though they might only apply in certain specific situations, were incompatible with the Parent Subsidiary Directive. The Court summarised the issue nicely, in paragraph 53, where it determined that –

> "Since the parent company's tax burden is likely to be affected, it must be concluded that the parent company is, as a result, indirectly taxed on the dividends received from its subsidiary".

This "indirect" taxing of the dividends at issue was in breach of the exemption regime contained in Article 4(1) of the Parent Subsidiary Directive.

Impact of the earlier *Cobelfret* decision

The *Cobelfret* situation,[6] after which Belgium changed its domestic rules to the ones challenged in *Brussels Securities*, concerned Belgian rules which implemented the Parent Subsidiary Directive by choosing the exemption method. Belgium included dividends covered by the Directive in the tax base of the parent company and allowed a deduction for 95%. However, in a situation where there was insufficient taxable income that deduction could not be carried forward into future years.

Cobelfret argued that this meant that its dividend income received under the Directive was not truly exempted from taxation in Belgium. The Court agreed, and pointed out in paragraphs 35-40 of *Cobelfret*, that the effect of the Belgian regime –

> "which provides that dividends received by the parent company are to be added to its basis of assessment and that subsequently an amount corresponding to 95% of those dividends is deducted from that basis only if there are taxable profits in the hands of the parent company, is that the parent company can benefit in full from that advantage only on condition that it has

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6 *Belgische Staat v Cobelfret NV ("Cobelfret"),* C-138/07, ECLI:EU:C:2009:82. For analysis, see Gauthier Cruysmans, "The Belgian participation exemption regime and the ECJ's decisions in *Cobelfret* and *KBC/BRB*", International Tax Report, Apr. 2010, pp 1-9.

> not suffered negative results for the same tax period with regard to its other taxable income …
>
> Member States cannot unilaterally introduce restrictive measures such as a requirement that the parent company have taxable profits and thus impose conditions on the possibility of benefiting from the advantages provided for in Directive 90/435 …
>
> in principle, Belgian tax legislation allows losses to be carried forward to subsequent tax years. Consequently, the reduction of losses to the parent company which could benefit from being thus carried forward up to the amount of the dividends received has an effect on the basis of assessment of that company during the tax year which follows that in which those dividends were received in so far as its profits exceed the losses which can be carried forward. Following the reduction in the losses which can be carried forward, that basis of assessment is increased …
>
> It follows that, even if the dividends received by the parent company are not subject to corporation tax for the tax year in the course of which those dividends were distributed, that reduction of losses of the parent company may have the effect that the parent company is subject indirectly to taxation on those dividends in subsequent tax years when its results are positive".

In paragraph 45, the Court pointed out that –

> "when the parent company does not make other taxable profits in the period during which the dividends are received, the DBI system does not allow the objective of preventing economic double taxation, as set out in the first indent of Article 4(1) of Directive 90/435, to be fully attained".

Final Thoughts

The judgment of the Court in *Brussels Securities* is in line with its earlier jurisprudence, as evidenced by the discussion on the *Cobelfret* judgment in the previous section. The Parent Subsidiary Directive seeks to achieve neutrality, from a tax point of view, when dividends are distributed by a subsidiary in one Member State to its parent company established in another. In order to ensure neutrality, the Directive aims to prevent double taxation of distributed profits, first, in the hands of the subsidiary and second, in the hands of the parent company. If the parent company loses the benefit of the DRC relief, under the exemption scheme put in place by Belgium, then, contrary to Article 4(1) of the Parent Subsidiary Directive, the receipt of such dividends is not fiscally neutral because the loss of a tax advantage (such as DRC) results in a higher tax burden in a cross-border inbound dividend situation.