Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared

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1. Introduction

This paper will compare a particular set of tax rules from the Brazilian and Belgian tax systems that, on a first glance, appear to have the same structure and purpose. Such rules are particularly interesting to compare because, to the best of our knowledge, they exist only in these two tax systems.

To summarize them, they provide for the possibility of an income tax deduction, by a corporation, of a fictional interest payment, calculated by the application of a long term interest rate over the corporate equity capital.

In Brazil, they are referred to as "Juros sobre o Capital Próprio" (it translates to interest on equity capital, hereinafter "JCP"), and were enacted in 1995, by Law n. 9.249[2]. In Belgium, they are commonly referred to as "Notional Interest Deduction" (hereinafter "NID"), enacted by Law of 22 June 2005[3] and also found in Arts. 205*bis* to 205*novies* of the Belgian Income Tax Code[4].

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[2] See Art. 9.

[3] Law of 22 June 2005 implementing the tax deduction for risk capital, *Belgian State Gazette*, at 1035.

[4] See A. Haelterman, H. Verstraete, *The "Notional Interest Deduction" in Belgium*, in Bulletin for International Taxation, Aug/Sep 2008, p. 362.

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Although the mechanisms are similar, it is necessary to proceed to a deeper analysis to determine if both sets of rules are comparable[5]. This paper will be aimed not only to outline such rules, but also to identify if: (i) they share a convergent underlying policy; (ii) they pose a similar solution to a similar problem; and (iii) there was any common or reciprocal influence on their drafting.

2. Brazilian "*Juros sobre o Capital Próprio*"

2.1 Background

The Brazilian JCP rules entered in force in January 1st, 1996 and were part of a broader package of tax and non-tax changes aiming at important economic goals in that period. One of the major economic concerns was to cut back inflation, which had reached peaking 50% monthly rates in 1994[6]. This goal was achieved by the "Real Plan", an economic plan that, in a short lag of time, succeeded in reducing inflation to averaging 20% per year (1.7% monthly average in the first semester of 1995)[7].

The economic plan had three key goals: (i) balancing the fiscal unbalance, in order to end the "inflationary tax"; (ii) accomplishing a monetary reform to restore the

[5] The comparative method set forth by Professor Carlo Garbarino (*An Evolutionary Approach to Comparative Taxation: Methods and Agenda for Research*, American Journal of Comparative Law, v. 57, Issue 4) provides the framework in which the comparative analysis made herein will be based upon.
[6] See Gustavo H. B. Franco, *The Real Plan*, discussion paper n. 354, 1996, available in http://www.econ.puc-rio.br/pdf/td354.pdf, p. 1. See also Ariovaldo dos Santos, *Quem está pagando juros sobre capital próprio no Brasil?*, 2006, available in http://www.scribd.com/doc/4710893/JUROS-SOBRE-CAPITAL-PROPRIO-NO-BRASIL, p. 34.
[7] Id. note 6. Of course, those are not really low rates by international standards and even by current Brazilian standards, but they are low if compared to the Brazilian inflation rates in the 1980s and early 1990s.

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functions of the national currency; and (iii) opening the economy with trade liberalization and a new foreign exchange policy[8].

Thus, it was necessary to restore the national currency as a parameter for pricing, ending a massive culture of indexation of the economy, which caused inertial inflation. This was achieved by the adoption of a fictitious unit of account – the URV (which stands for "Unidade Real de Valor") – that was initially paired to the Dollar and readjusted daily by a blend of price indexes to reflect current inflation. After the adoption of such unit, wages and other prices were progressively converted into it and other indexation mechanisms were abolished. The last step was to change the currency – by then, the "Cruzeiro Real" – into a new one, the "Real", which was actually the URV issued as a "full currency", and not only as a mere unit of account[9].

Law n. 9,249 enacted part of the major tax reforms ongoing in this period. Besides the enactment of the JCP rules, it exempted from taxation the dividend distributions made by any Brazilian legal entity[10] and, to stop inertial inflation, it prohibited the automatic indexation of any contract, including wages and rents[11]. Accordingly, Law n. 9,249 repealed the inflation adjustment of legal entities' financial statements[12] for tax and corporate purposes. It also reduced the corporate income tax rate[13].

In order to understand how the JCP rules relate to this context, the next item will first analyze the basic mechanisms of the JCP payments and their taxation. Then, the following items will provide some justifications for the enactment of such rules and policy goals related thereto.

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[8] See Gustavo H. B. Franco, *op cit*, p. 1. The fundamentals of the plan differed largely from earlier unsuccessful attempts to control inflation (e.g. the freezing of prices or temporary confiscation of bank accounts). See Ariovaldo dos Santos, *op cit*, p. 34.
[9] See Gustavo H. B. Franco, op cit, p. 9-10.
[10] See Law n. 9,249/95, Article 10.
[11] See Ariovaldo dos Santos, op cit, p. 34.
[12] Article 4.
[13] See Eliseu Martins, *Juros sobre o Capital Próprio – Aspectos Conceituais*, in Boletim IOB, Temática Contábil e Balanços, n. 50/96, 1996, p. 510.

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2.2 JCP Mechanism[14]

Article 9 of Law n. 9,249 established the mechanism for the JCP payments, providing for its amount, limitations and tax treatment.

Accordingly, a legal entity[15] can opt to pay interest on its own capital (i.e., JCPs), calculated by the application of a long term interest rate set by the government (TJLP – "Taxa de Juros de Longo Prazo") over the entity's equity (i.e., net assets[16]). JCPs can only be paid up to half of the amount of (whichever is higher): (i) the entity's profits of the current year, before the JCP's deduction; or (ii) the entity's accumulated profits[17].

Thus, to calculate the amount of JCP an entity can pay, one must first apply the TJLP rate over its net worth. The result will be limited by the highest between (i) half of the profits of the current year; or (ii) half of the accumulated profits.

On the one hand, the reasoning behind limiting the JCPs to the TJLP rate over the entity's net worth shows that it has an interest nature, given that it is assumed that the TJLP should represent the return that the capital would earn in a long term financial investment[18] made by the share/quota holders. On the other hand, the

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[14] See, in general, for an analysis of the legal mechanism of JCP payments and its taxation, Ricardo Mariz de Oliveira, *Juros de Remuneração do Capital Próprio*, in Revista de Direito Tributário Atual. Also, see Gervasio Recktenvald, *O dimensionamento dos benefícios fiscais a partir do pagamento de juros sobre o capital próprio*, in Revista de Estudos Tributários n. 5, Jan/Feb 1999.
[15] To be able to take the deduction and actually benefit from the JCP payment, the legal entity must be taxed by the "net profit system", as opposed to the optional presumptive income tax system. Both are systems foreseen by Brazilian law for taxing legal entities' profits by the corporate income tax and social contribution. Under the "net profit system", the actual corporate profit (adjusted by tax rules) serves as a base for the income tax. Under the "presumptive system", the taxable base is calculated by a percentage of the entity's gross receipts, without any regard to expenses. Thus, entities that opt for presumptive system cannot take any JCP deduction.
[16] Net worth accounts that relate to non-taxed market valuation of the entity's fixed assets must be excluded for this purpose. Basically, assets are taken on a cost basis, reduced by depreciation expenses already taken for tax purposes.
[17] Profits of the current year and accumulated profits do not mix together for this purpose.
[18] This is not necessarily true, as TJLP rates may be lower than market rates.

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limitations that refer to the profits of the company emphasize the dividend nature of the JCP and its relation to the Brazilian integration policy[19].

Up to the aforementioned limits, JCPs paid by a legal entity can be deducted from its taxable income. Such income is taxed in Brazil by a 25%[20] corporate income tax, plus a 9% social contribution. This amounts to a 34% rate over the corporate income. Thus, considering the corporate taxation alone, the deduction represents savings of 34% over the JCP paid.

Such payments are, however, taxable income of the recipients. First of all, regardless of who the recipient is, the JCP payments are subject to a 15% tax to be withheld by the payor.

If the recipient is an individual, such withholding is final, meaning that the JCP income is flatly taxed only by the withholding tax and does not mix with the rest of the individual's ordinary income or deductions. JCP income earned by non-resident share/quota holders are also subject to the 15% flat withholding tax.

If the recipient is Brazilian a corporation, the JCP payments received will be included in the corporate taxable income, subject to the aforementioned 34% rate. The 15% tax previously withheld will be considered anticipation and will be credited against the recipient's corporate income tax. Also, other social contributions with rates up to 9.25% might be levied over the JCP revenues of the recipient entity.

Finally, one should note that the deduction is linked to the corporate decision to pay the JCP and the corresponding taxation of the beneficiary. Thus, for Brazilian tax purposes, JCPs are treated as a special kind of interest payment and, as such, will be deducted from the payor's income and included, at the same time, in the payee's taxable income.

[19] See below for further analysis. Note, however, that the reason why the deduction is limited to half of the current or accumulated profits (instead of all of them) seems a bit blurred and is hardly explainable without considering a possible congressional purpose of limiting forgone tax revenues.

[20] The actual corporate income tax rate is 15%, but there is an additional 10% that is levied over the income that surpasses R$ 240,000.00 a year.

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Nonetheless, there is no money flow requirement. The payor is allowed to register the JCP payment as a liability or, by shareholders' decision, the declared JCPs can be recapitalized[21]. In either case, the payor can deduct the JCPs, even though no actual payment has been made to the payee, and the payee will be taxed at the same moment the deduction is taken. Thus, regardless of the money flow, the payor's deduction is fully linked to the payee's taxation. This is a crucial aspect of the Brazilian mechanism that differs from the Belgian NID, as will be discussed below.

2.3 JCP, Integration, Thin-Capitalization and Tax Expenditures

Given the mechanism described above, the JCP rules could be viewed as a method of integration[22] of the corporate and individual income tax systems[23]. This approach is most likely to be accepted if one takes the position that JCP payments have the nature of dividend payments.

As a matter of fact, there are strong arguments to make a case for the qualification of the JCPs as dividend payments[24], as they: (i) are only allowed if there are current or accumulated profits; (ii) do not arise from a debt obligation, but from equity

[21] I.e., an equity capital increase of the payor corporation.

[22] As J. Slemrod and J. Bakija (*Taxing Ourselves: A Citizen's Guide to the Debate over Tax Reform*. Fourth edition, Cambridge, MA: MIT Press, 2008, p. 398) state, integration of the corporate and individual income tax systems is a way to mitigate (or eliminate) double taxation of corporate income by some form of relief from tax for dividends and (sometimes) capital gains, on which corporate income tax has already been paid. See also WARREN Jr., Alvin C., *Integration of the Individual and Corporate* Taxes, American Law Institute, 1993 for details on integration methods and their implications.

[23] Heleno T. Torres (*Juros sobre Capital Próprio: autonomia privada nos investimentos societários e suas implicações em matéria tributária*, available in http://www.scribd.com/doc/7037585/Juros-Sobre-Capital-Proprio-Prof-Heleno-Taveira) argues for this approach.

[24] See Alberto Xavier, *Natureza Jurídico-Tributária dos Juros Sobre o Capital Próprio Face à Lei Interna e os Tratados Internacionais*, in Revista Dialética de Direito Tributário n. 21, p. 7. Due to these characteristics and in pursue of reaching uniformity in corporations' financial statements, the Brazilian Securities Exchange Commission (Comissão de Valores Mobiliários - "CVM") has issued a ruling (Deliberação CVM n. 207 of 12.13.1996) requiring that corporations treat JCP payments as dividend distributions on the financial statements they publish.

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investments; and (iii) can offset the mandatory dividends required by the corporate law[25].

However, if one considers that JCP payments account for inflation adjustments and opportunity costs, there are also strong arguments favoring the interest nature of such payments, as JCP deductions would in fact take out items from the corporate taxable income that are not part of its genuine profits.

Although this discussion is relevant, especially for purposes of qualification under tax treaties[26], it will not be further analyzed here. For our purpose, it suffices to say that the JCP payments share characteristics with dividends and interest. Thus, it is equally important to analyze the rules in light of the Brazilian integration policy, emphasizing their dividend nature, and in light of interest taxation and inflation adjustment policies, emphasizing their interest nature.

As mentioned earlier, from 1996[27] on, Brazil has adopted a general integration policy that exempts from taxation all dividends distributed by Brazilian corporations[28]. Dividend distributions, however, are not deductible from the corporate income tax. The JCP rules, on the other hand, allow for the deduction, by the distributing corporation, of the JCP "distributions" to the shareholders. Thus, such rules could be viewed as parallel and optional "dividend paid deduction"[29] integration method.

One should note that, if the individual and corporate income tax rates were identical and flat, the overall combined taxation of the shareholders and the corporation

[25] Law n. 9,249/95, Article 9, §7 and Law n. 6,404/76, Article 202.
[26] It is unclear if JCP payments should be qualified under articles 10 or 11 of double tax treaties following the OECD model convention. Considering that Brazilian treaties might provide for different withholding caps in each of these income categories and, moreover, might provide for matching credits, the issue is of great relevance.
[27] See Law 9,249, Article 10.
[28] Dividends are excluded from the individual and corporate income tax and no withholding tax is imposed upon distribution, even if the beneficiary is non-resident. Also, if dividends are capitalized and new shares are issued (i.e., a stock dividend), a basis step-up is granted to the shareholders (i.e., the new shares will have a basis equal to the amount of dividends capitalized; if no shares are issued, the old shares' basis is stepped up), allowing, thus, the integration policy to also reach capital gains' taxation
[29] See Heleno T. Torres, *op cit*, p. 10.

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would be identical[30] under the exemption or the dividend paid deduction method. Also, in this scenario, there would be no incentive or disincentive as to capitalization through equity or debt.

That is, under the exemption method, the dividend payments being non-deductible and tax exempt, and interest deductible and taxable on the beneficiary, there would be no actual tax incentive or disincentive as to debt or equity capitalization, as long as corporate and individual taxation occurred at the same rates. The decision should be tax neutral, because the overall corporate/shareholder taxation would be the same in both cases[31].

The same story could be told under the dividend deduction method: it would be neutral as to debt or equity capitalization because both would entail the same overall taxation, given the fact that both interest and dividends are deductible by the corporation and taxable at the hands of individuals.

However, if there are progressive rates and/or if the individual and corporate income tax rates do not match, the exemption and deduction methods can lead to dissimilar results, because the tax value of the deduction for the corporation would be different than the actual taxation on the individual level.

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[30] Of course, on the deduction method, as the distribution might not occur in the same year the corporate income was earned, there would be some timing differences. Also, see note 31 infra for other arguments that might challenge this statement.

[31] One must recognize, however, that this reasoning can be challenged on many grounds. Timing and compliance issues can play, for one, an important role on differentiating both alternatives. Moreover, and more important than that, if one follows Reuven Avi-Yonah's (*Corporations, Society and the State: a Defense of the Corporate Tax*, Virginia Law Review, v. 90, n. 5, 2004) view that the corporate income tax have corporate governance purposes in regulating the administration of public corporations, and that administrators care more about the corporate income tax than the individual income tax, having a deduction from the corporate income tax and concurrent taxation of the individual shareholders would have a higher value for the administration than not having such deduction and having an exemption for the individual shareholders. If this is true, administrators would always prefer to capitalize through debt or to take advantage of rules that allow a deduction for payments to shareholders. Finally, one must realize that tax exempt shareholders, such as pension funds, might prefer papers whose payments grant a deduction to the corporation. See Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 Va. L. Rev. (2009), for discussions on the various conflicting interests on different integration policies. See also Reuven Avi-Yonah, *Back to the 1930s? The Shaky Case for Exempting Dividends*, Tax Analysts, 2002.

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Also, if the taxation of interest received by individual bondholders does not match the corporate tax value of the interest deduction taken by the corporation, there will be a tax incentive towards debt or equity capitalization under an exemption system. This incentive would not occur under a dividend paid deduction method so long the individual income tax rates for dividends and interests were the same.

In the Brazilian case, the individual and corporate income tax rates do not match. For interest income, the individual income tax rate is lower than the corporate tax rate, which creates a bias towards debt capitalization under the exemption method. Interests' income earned by Brazilian individual bondholders is taxed at schedular flat rates that range from 22.5% to 15%[32]. This means that while the interest payment deduction represents a 34% tax value to a profitable corporation, its taxation on the individual level will not be higher than 22.5% and can be as low as 15%. Hence, interest payments to individuals can represent an overall tax savings of up to 19%[33] of the interest value.

Thus, even though Brazilian law provides for full integration by dividend exemption, there is still a tax bias to capitalizing corporations through debt, instead of equity[34]. One should note that, as there are no rules[35] limiting the amount of (deductible)

[32] The rates are: 22,5% (loans of 180 days or less); 20% (181 days to 360 days); 17.5% (361 days to 720 days); and 15% (over 720 days). See Law 11,033/2004, article 1.

[33] 34% deduction value for the corporation, minus 15% individual income taxation.

[34] In a system integrated by the dividend exemption, the net earnings on the equity investment would be E(1-c) and the net earnings on the debt investments would be E(1-p), where *c* is the corporate income tax rate and *p* the individual income tax rate on interest. If *p* is lower than *c*, as it is in Brazil, there is an incentive to debt capitalization, even if the system is integrated through the dividend exemption method.

[35] Until December 2009, Brazil did not have any explicit thin capitalization rule. After December 15, 2009, Brazil has a thin capitalization rule the limits the deduction of interests paid to foreign related parties (see Medida Provisória nº 472, of December 15, 2005, Articles 24, 25 and 26). Only interest arising from liabilities that do not exceed an amount equal to twice the equity capital held by the foreign related party will be deductible. If the payee is resident in a tax haven, interests will be deductible only if arising from liabilities that do not surpass 30% of the Brazilian company's equity capital. This is independent on the foreign payee being related to the Brazilian company. The deduction of interest paid to non-resident related parties is also limited in its value, as it cannot be higher than LIBOR plus 3% (See Brazilian Income Tax Code – Regulamento do Imposto de Renda: Decreto n. 3,000/99 –, article 243. If the contract is registered at the Brazilian Central Bank, the IRS should accept the interest rate authorized by the Central Bank. However, the Brazilian IRS has been challenging such interest rates and applying the LIBOR plus 3% standard after registering rules of the Central Bank have been relaxed).

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interests that can be paid to Brazilian resident (related) bondholders[36], the aforementioned tax advantage that arises from interest payments can lead to the thin capitalization of Brazilian legal entities.

The JCP rules are a way that Congress found to mitigate this flaw of the exemption system, as they seek to reestablish the equal tax treatment of debt and equity, in order to reduce the bias towards debt capitalization. This result is reached through a method that resembles the "dividend paid deduction" method: some of the corporate profits can be paid to the shareholder as if they were debt payments. Thus, JCP payments generate a 34% tax value deduction for the corporation and are taxed at a 15% flat rate on the individual recipients. In other words, JCP payments generate an overall tax savings of up to 19%, just like the interests paid on corporate bonds to individual bondholders.

Thus, JCPs make the Brazilian tax system more neutral as to corporate capitalization by granting equity an advantage similar to debt. The beneficial tax treatment of debt capitalization does not arise from the fact that the Brazilian system in not integrated, but from a natural deficiency of the exemption system in dealing with rate differences between the corporate and individual income taxes. The Brazilian solution was to come up with the JCP deductions, which allows interest treatment for corporate distributions that do not exceed a long-term interest rate over equity capital.

Items10 and 11 of the Statement of Legislative Intent of Law 9,249 seem to point out this very goal of the JCP rules by stating that: "*10. In order to equalize the taxation of the many types of capital income, the law brings the possibility of remuneration of equity capital invested in productive activity by means of deducting interests paid to the shareholders, up to the limit of the TJLP*; and *11. Allowing the deduction of the interests, up to the proposed limit, should especially cause an increase in the productive capitalization of Brazilian companies, allowing them to*

[36] There are statutory rules that limit the corporate tax deduction to market price interests paid to bondholders who are also shareholders. See Brazilian Income Tax Code, article 464.

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increase the level of investments, without indebtedness, with clear advantages regarding employment and sustainable growth of the economy".

Thus, Congress signals its will to offer corporations a means to make use of deductions on the payments of equity capital investments and, thus, avoid thin capitalization through debt. This does not mean, however, that the JCP rules are some sort of tax expenditure[37] to subsidize equity capitalization. Such rules are part of the Brazilian benchmark tax system, which would be otherwise distortive.

2.4 JCPs and the Repeal of the Financial Statements' Inflation Adjustments

The aforementioned goal becomes even clearer if one considers the effects of the repeal of the financial statements' inflation adjustment rules in 1994[38]. Before the enactment of Law n. 9,249, legal entities subject to the corporate income tax adjusted their financial statements for inflation. The Brazilian system applied the inflation adjustment to the net worth of the entity as a way to verify the net inflation impact over assets and liabilities accounts. Inflation being positive, the increase in net worth would be matched by a deductible expense registered in the taxable year's result[39].

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[37] It should be noted that the JCP rules are not accounted for in the Brazilian Tax Expenditure Budget of 2009 (See Receita Federal do Brasil, *Demonstrativo de Gastos Tributários* - 2009, 2008, available in http://www.receita.fazenda.gov.br/publico/EstudoTributario/BensTributarios/2009/DGT2009.pdf) what means that the IRS shares this view. One should note, moreover, that the Brazilian tax expenditure budget takes a broad view on tax expenditures.

[38] Vinicius Branco (*Da não incidência das contribuições para o PIS e COFINS sobre os valores recebidos a titulo de juros sobre o capital próprio*, in Revista Dialética de Direito Tributário n. 115, p. 117) recognizes that, in spite of this Congress' justification for the JCP rules, their true goal was to make up for the repeal of the inflation adjustments of the financial statements.

[39] Also, the law provided for an independent inflation adjustment of fixed assets account. The adjustment of the fixed assets' value would be matched by revenues registered in the taxable year's result. However, these revenues were excluded from the taxable income and would only be taxed upon the realization of the asset. This is the same as saying that for tax purposes no adjustment on the basis of such assets was made, and capital gains were taxed on realization considering a cost basis. See Eliseu Martins, *Origem do modelo brasileiro de correção monetária das demonstrações financeiras*, in Boletim IOB – Temática Contábil e Balanços, Bol. 49/2004, p. 1-5.

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The inflation adjustment reduced the taxable income of entities with positive net worth. As a result, its repeal left taxpayers worse off. One could argue that this was compensated by the reduction of the corporate income tax rate enacted along with the repeal of the inflation adjustment. However, an inequity would remain and would even be worsened by the simple reduction of the corporate income tax rate[40]. Such inequity relates to the different treatment rendered to entities capitalized by equity and debt.

Before the repeal of the inflation adjustments, debt capitalized entities would deduct as financial expenses all the interest they paid and inflation adjustments embedded therein. Equity financed entities, on their turn, were able to deduct the inflation adjustment of their net worth. After the repeal of the inflation adjustments, a debt capitalized entity would still be able to deduct inflation and effective interests on its liabilities (both embedded on the interest payments), while the equity financed company would not be able to deduct any expenses regarding its capital. Thus, such a change would create a problem of equity[41] and inefficiency as to debt/equity financing.

One could argue, however, that this is just an apparent problem, because the dividend exemption method would make up for the lack of deduction of the inflation adjustments. In other words, debt capitalized companies would be able to deduct interest (and inflation), but the interest payments would be taxed on the hands of their recipients. Equity financed companies, on their turn, would not deduct anything, but would pay tax exempt dividends to its shareholders. On the balance, things should even out if all rates were the same. However, as already shown in item 2.3 above, rates are not the same and debt capitalization would be favored. Thus, to level the playing field, Congress enacted the JCP rules.

[40] See Eliseu Martins, *Um pouco da historia dos juros sobre o capital próprio*, in Boletim IOB – Temática Contábil e Balanços, Bol. 49/2004, p. 2.
[41] Maybe not an everlasting problem of equity, as market pricing mechanisms could adjust the prices of equity and debt instruments to the new reality, but there would at least still be a transitional equity problem.

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3. Belgian NID

3.1 Background

As of January 1st 2006, Belgian companies (or Belgian PEs of foreign companies[42]) subject to the Belgian corporate income tax can benefit from a Notional Interest Deduction. The NID[43] rules, broadly speaking, allow for a deduction of the risk-free remuneration component related to the equity funding of a corporation. Thus, for tax purposes, it is deemed that the company has borrowed its own equity funds and the notional interest related thereto can be deducted from the corporate income tax base[44].

These rules were enacted after the European Commission found that the Belgian coordination centers regime did not comply with the EC Treaty's State Aid rules[45], which caused its progressive repeal by Belgium[46]. Taking the view that the NID embodies a valuable tax benefit, the Belgian government promoted it in roadshows across the United States, Asia and several European countries, in 2005[47]. Also, in 2008, it launched a campaign to promote Belgium and featured the NID as an attractive benefit[48].

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[42] See Bernard Peeters, Nico Demeyere, *American Bar Association Foreign Lawyers Forum – Belgium Annual Report* 2007, 2008, p. 2. See also Axel Haelterman, Henk Verstraete, *The "Notional Interest Deduction" in Belgium*, in Bulletin for International Taxation, Aug/Sep 2008, p. 363.
[43] NID was the common name adopted for the whole set of provisions that the Belgian Income Tax code treats as "Déduction pour capital à risque" in Sub-section IIIbis.
[44] See Axel Haelterman, Henk Verstraete, op cit note 4, p. 362.
[45] EC Treaty.
[46] See item 3.5 infra. See also Axel Haelterman, Henk Verstraete, op cit note 4, p. 362; Eric Osterweil, Marc Quaghebeur, *Taxation of Companies under Belgium Income Tax Law*, in Bulletin for International Taxation, Aug/Sep 2008, p. 347; and Jacques Malherbe, *Promovendo a Competitividade no Âmbito das Regras da Comunidade Européia Relativas a Auxilio Estatal e Concorrência Fiscal Prejudicial: o Exemplo da Bélgica*, in Revista de Direito Tributário Atual v. 20, p. 75-89.
[47] See Axel Haelterman, Henk Verstraete, op cit note 4. See, also, the Business Memo from Belgium, published by the Embassy of Belgium in Washington. DC, promoting the NID rules: http://www.diplobel.us/NewsPublications/BusinessMemo/2006/BM012006.pdf.
[48] See Axel Haelterman, Henk Verstraete, op cit note 4, p. 362. The campaign is entitled "Only in Belgium"; see www.invest.belgium.be.

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In late 2007 and early 2008, with the forming of the new government after the 2007 elections, the NID rules were debated (especially because their budgetary impact had proven to be higher than initially expected) and it was decided that some anti-abuse measures were necessary to challenge some loopholes of the system. Accordingly, in 2008, Tax Authorities issued a circular – Tax Circular AFER-AOIF n. 14/2008 of April 3rd 2008, published on April 9, 2008 – to deal with the possibility of abuse, but the NID rules themselves were not changed.

The preparatory works of the NID law, as well as Tax Circular AFER-AOIF n. 14/2008, show that it was enacted for the following reasons[49]: (i) to reduce the fiscal discrimination between debt and equity; (ii) to enhance the equity of companies (especially small and mid-sized companies) and increase solvability; (iii) to maintain and further develop small and mid-sized companies; and (iv) to provide for an alternative to the Belgian coordination center regime[50]. As an average, calculations show that the NID deduction has reduced the corporate income tax rates from 33.99% to about 26%-27%[51].

3.2 Overview of Belgian Integration, Debt/Equity Discrimination and Thin-Capitalization

Before analyzing the particularities of the NID rules, it is important to provide an overview of the Belgian tax system as to the way in which it taxes dividends and interest paid by corporations.

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[49] See Preparatory Works, Parl. Doc., House of Representatives 2004-2005, n. 51-1778/001, at 4-6, *apud*, Axel Haelterman, Henk Verstraete, op cit note 4, p. 362.
[50] Tax Regulation AFER-AIOF n. 14/2008 adds that the purpose of the NID rules is also to maintain Belgium's embedment of large industrial groups, their financial systems and services.
[51] See Axel Haelterman, Henk Verstraete, op cit note 4, p. 363. It is expected that the NID may "cost" 10 billion euros for tax year 2008 (calendar year 2007) (Trends-Tendances, 10 December 2009, p. 19).

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Belgium has a corporate income tax levied at a rate of 33%, plus a surcharge of 3% of the tax, resulting in a rate of 33.99% on the corporate income[52]. Dividends are not deductible by the corporation and (differently than in Brazil) are taxed when distributed. Thus, the Belgian system is not fully integrated, as corporate income is taxed twice: once at corporate level, and a second time at shareholder level, when distributed. A tax of 25%, which may be reduced to 15%, is withheld on the dividends paid by Belgian corporations[53]. However, dividends paid to corporate shareholders can qualify for a 95% participation exemption under certain conditions.

Interest payments, on their turn, are deductible from the corporate income tax base, and constitute taxable income of the beneficiary, generally subject to a 15% withholding tax[54]. Given the fact that the Belgian tax rates on interests received by individuals are equal or lower than the rates on dividends and that interests are deductible while dividends are not, there is a bias towards debt capitalization under the Belgian system[55].

Before the NID rules, the only way to control the preference for debt was through thin capitalization rules[56]. The NID rules, as they allow a deduction from the corporate income tax base according to the amount of equity capital, can be viewed as a mechanism to correct the imbalance towards debt over equity. In other words,

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[52] Art. 215 of the Belgian Income Tax Code. See Eric Osterweil, Marc Quaghebeur, op cit, p. 348.
[53] See Eric Osterweil, Marc Quaghebeur, op cit, p. 348. The 15 % rate is applicable to shares issued against cash after 1994 and which were not to bearer (Art. 269 of the Belgian Income Tax Code). The shares may not be privileged and a capital increase should not compensate a capital reduction.
[54] The withholding can be waived in payments to corporate beneficiaries, under certain conditions. The 15% withholding is a final taxation in case of individuals. See Eric Osterweil, Marc Quaghebeur, op cit, p. 348.
[55] Such bias can be mathematically expressed as: Net return on equity: $(1-p)E(1-c)$; Net return on debt:
$(1-p)E$; where p is the individual income tax rate, c is the corporate income tax rate and E is the income earned. Net returns on debt investments would be clearly favored, as they are free from the corporate tax.
[56] In fact, Belgian law has two main thin-capitalization rules: (i) interest paid to tax free or foreign beneficiaries in a low tax country are not deductible on the part of the loan that exceeds seven times the paid in capital of the company; and (ii) interest paid on loans granted by individual shareholders or directors are deductible only to the extent that they are at market rate and that the loans do not exceed the company's paid in capital. Excess interest is recharacterized as a dividend. See Eric Osterweil, Marc Quaghebeur, op cit, p. 350.

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with the NID rules, equity investments offer certain deductibility from the corporate income tax base, which make them more attractive.

3.3 NID Mechanism Overview

Article 205bis of the Belgian Income Tax Code determines that an amount called the "Risk Capital Deduction" or "Notional Interest Deduction" (i.e., the NID) can be deducted from the corporate income tax base. The risk capital is determined according to the rules of Article 205ter and the amount of deduction is calculated by applying the indexes set forth by Article 205quater to the capital at risk. Article 205quinquies deals with the deduction carryforward and Articles 205octies and 205novies (read nonies) deal with the corporations that are not allowed to take the deduction[57].

The NID regime applies, in principle, to all entities[58] subject to the Belgian income tax. However, there are some entities that are excluded[59], such as those still subject to the coordination centers' regime[60].

The deductible NID amount is equal to the company's risk capital multiplied by an interest rate equal to the ten-year long-term linear government bonds ("*OLO bonds*")[61]. The rate is adjusted annually and it is the average rate of the year before the accounting period to which the taxable year refers. For 2010 (accounting period

[57] Commentary in Circular Ci. RH 42/574.445 (AFER-AOIF 36/2008) of 9 October 2008.

[58] An entity may optionally decide not to apply NID rules. However, if it does so, the deductions for the particular year are lost (i.e., cannot be deferred for a future year). The only apparent reason to opt out of the NID rules would be due to the application of foreign rules (such as CFC rules), possibly of the country of the parent of a Belgian company or branch. See Axel Haelterman, Henk Verstraete, op cit, p. 364.

[59] See Axel Haelterman, Henk Verstraete, op cit, p. 364.

[60] Because the NID rules, to a certain extent, were enacted to grant a benefit similar to the one granted by the coordination centers' regime, it would not make sense to apply both rules to the same entity.

[61] See Jacques Malherbe, op cit, p. 76; Axel Haelterman, Henk Verstraete, op cit, p. 364

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2009), the rate was 4.473%[62]. Such rate cannot exceed 6.5%, unless allowed by a Royal Decree[63].

The risk capital is the company's equity capital (net assets) as it appears in its non-consolidated annual accounts of the preceding year, discounted by some items. The risk capital exclusions from the net assets may serve the purpose of avoiding abuse or the cascading use of the deduction[64].

To avoid the cascading use of the NID, shares qualifying as fixed assets[65] must be excluded from the company's net assets. The rationale is straightforward: the value of such shares represents the net assets of a subsidiary that will use the NID deduction. The dividends of such subsidiary, on their turn, will qualify for the 95% participation exemption and, thus, will not be taxed on the parent[66]. Allowing the parent to calculate its NID deductions taking into account the value of the subsidiary's shares in its net assets would allow for a double deduction on profits that are taxed only once under the corporate income tax (i.e., taxed only at the subsidiary's level, and not on the parent's level). On the other hand, shares that do not qualify as fixed assets and, thus, whose dividends are not subject to the participation exemption, can be included in the risk capital for NID calculation purposes, because no double-dip effect would occur.

This rule shows, on the one hand, that the Belgian NID deduction actually relates to income tax integration purposes, as the deduction is restricted to cases of double taxation of dividends. On the other hand, it also shows that the NID system does not tie the deduction of the NID interest to the taxation of the shareholder. In fact, the NID deduction can be taken by the corporation regardless of any distribution (or

[62] See Axel Haelterman, Henk Verstraete, op cit, p. 369. The rate for 2008 was 3.781% and for 2007 it was 3.442%.
[63] It will be capped at 3.8 % starting in 2010.
[64] See Axel Haelterman, Henk Verstraete, op cit, p. 365.
[65] Also shares in investment companies that qualify for the 95% dividend received deduction.
[66] Although this is the rationale of the rule, there is not a direct and automatic relation between the qualification of a share under a fixed asset account and its qualification for the participation exemption. See Axel Haelterman, Henk Verstraete, op cit, p. 365.

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taxation thereof) to the shareholders. Moreover, the profits distributed will still be characterized as dividends.

This is one fundamental difference between the Belgian NID and the Brazilian JCP mechanisms. Under the Brazilian JCP system, if the corporation decides to pay interest on its own capital, the tax law deems such payments to be an actual (special kind) of interest. There is a direct relation between the deduction of the JCP payments and their tax treatment on the shareholder that receives them. The consequence is that, once an amount is paid as JCP by the corporation, it ceases to be treated as a dividend for tax purposes, becoming a deductible expense of the corporation and taxable income of the payee[67]. This requalification is necessary in Brazil because dividends are always exempt from tax. Thus allowing the deduction of a JCP payment and, at the same time, its treatment as dividends for shareholder tax purposes would create an unwanted double benefit.

The Belgian system does not need a rule that ties the deductions to the payments because dividends are taxed in Belgium. Accordingly, allowing the NID deduction and the distribution of the corporation's profit as a dividend would not generate a double benefit[68]. The only occasion when such double benefit would occur is when the dividends qualify for the participation exemption. This case, however, is dealt by the special rule that excludes the subsidiaries' shares from the risk capital, as mentioned above.

The second set of items that must be subtracted from the risk-capital are assets whose income is not taxable in Belgium[69]. This relates to permanent establishments or real estate located in countries with which Belgium has a tax treaty that exempts Belgium from taxing the income derived therefrom. Thus, the book value of such

[67] For this reason, the Brazilian system does not need to exclude (as the Belgian system does) the shares in subsidiaries from the parent's net assets used to calculate the JCP. The inclusion of such shares will not result in a cascading deduction. The JCP deduction of the subsidiary will be matched to the taxable income of the parent. If the parent also wants to pay JCPs, it can and will deduct them. Its shareholders, however, will be taxed on their JCP income.
[68] However, timing issues are relevant, as will be shown under item 3.4.2 below.
[69] See Axel Haelterman, Henk Verstraete, op cit, p. 366. The compatibility of this restriction with EC law has been questioned (letter of the European Commission to Belgium, 19 February 2009).

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assets must be excluded from the risk-capital. The reason for such exclusion is that the NID rules are meant to allow the deduction only for equity that generates income taxed in Belgium. The tax consequences of the costs of financing, whether by equity or debt, the assets that produce income taxed only elsewhere should be assessed by the country in which such assets are located and have their income taxed[70].

The last set of exclusions is meant to prevent abuse through the inflation of a corporation's equity in order to increase the amount of NID[71]. Thus, unreasonable investments, assets held only as passive investments and which do not produce ordinary income and real estate used by the officers of the company must be subtracted from the risk-capital[72]. Finally, tax exempt elements that change the equity value of the company must also be excluded[73]. This happens with the non-taxed revaluation of assets. The same rule applies to the Brazilian JCP, regarding non-taxed reevaluation reserves. Thus, only the cost basis of the assets is considered.

The anti-abuse exclusions are not necessary under the JCP rules because non-profitable items that only inflate the entity's net worth would not increase the amount of JCPs, since JCP payments are limited 50% of the company's current or accumulated profits. The NID deductions, on the other hand, as they are taken independently of any payment to (or taxation of) the shareholders, are not subject to any of such limitations. Thus, a company can take the NID deductions even if such deductions are actually higher than its taxable income.

In this case, the unused NID can be carried forward for seven years[74]. To maximize the use of the NID's, they are accounted for after the dividend received deduction

[70] See Axel Haelterman, Henk Verstraete, op cit, p. 366.
[71] Such rules do not exist in the Brazilian system. However, due to the limitations on the JCP payments to half of the current or accumulated profits, they do not seem to be necessary.
[72] See Axel Haelterman, Henk Verstraete, op cit, p. 366. Jacques Malherbe, op cit, p. 77
[73] See Axel Haelterman, Henk Verstraete, op cit, p. 366.
[74] See Haelterman, Henk Verstraete, op cit, p. 369; Eric Osterweil, Marc Quaghebeur, op cit, p. 34, and Jacques Malherbe, op cit, p. 77.

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(which cannot be carried forward - except where the EC parent-subsidiary directive applies -) and before the net operating losses carryforwards of previous years (which can be carried forward indefinitely).

3.4 Relation to Integration, Opportunity Costs and Tax Expenditures

As mentioned before, the NID rules can be viewed as a way to mitigate the bias of the Belgian tax system towards debt capitalization and, in this sense, are comparable as a policy to the Brazilian JCP rules.

Without regard to timing issues (which will be analyzed below), assuming that all profits of a Belgian corporation in a year will be distributed, the difference between the Belgian system without and with the NID deductions can be represented as follows:

NET EARNINGS IN SYSTEM WITHOUT THE NID	NET EARNINGS IN SYSTEM WITH NID:
(1-p)*E*(1-c)	(1-p)*E*(1-c)+(K*NIDi*c)*(1-p)

Note that *p* is the individual income tax rate, *E* is the income earned and distributed, *c* is the corporate income tax rate, *K* is the risk-capital over which the NID deduction is calculated and *NIDi* is the interest rate by which the NID deduction is calculated. Note that the formula only works if E is higher or equal to (K*NIDi*c), i.e., if the company's income is higher than the NID deduction. If it is lower, there will be a loss, whose treatment we will explore further in item 3.4.1 below.

The formula shows that the net earnings increase by the amount of corporate income tax saved by the NID deduction, net of the individual income tax. In an actual dividend paid deduction system, the full amount paid to the shareholder

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would be deducted. This may only happen under the NID system if the earnings match the NID deduction (i.e., if E = K*NIDi). Thus, the NID system is not a full method of integration, but at least it is meant to relive the double taxation over the part of the return on the equity investment that refers to long term interests. In other words, if one considers that long terms interest rates are the opportunity cost of an equity investment (or, at least, the best proxy thereof), the NID system relieves the double taxation on that portion of the return. Earnings above it would still be double taxed.

In what refers exclusively to the revenue cost per taxpayer of this integration relief, it can be represented by (K*NIDi*c)(1-p). It is an unsettled issue if this revenue should be considered a tax expenditure, as it depends on the adopted benchmark. If one considers that a classical system – i.e., no integration whatsoever – is the benchmark for the taxation of corporate earnings, this revenue cost would be a tax expenditure. However, if one takes the view that policy should aim at some sort of integration, this revenue cost should not be considered a tax expenditure. Regardless of the point of view, it seems fair to say that there is at least a strong underlying policy goal supporting integration, which is not related to a tax subsidy per se.

But the Belgian NID rules and their respective revenue costs go beyond the simple cost described above and the goals of integration. There are two particularities of the NID system that drive it away from the goals of integration and bring higher revenue costs than the one described until now. These particularities are the following: (i) NID deductions are not limited to the company’s profits and a carryforward for unused deductions is allowed; and (ii) NID deductions do not match, in time, the shareholder’s taxation, what means that it applies even when the profits are retained in the company to later distribution. Each of these particularities and respective tax consequences will be analyzed separately below.

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3.4.1 Deductions are not limited to profits

If the only goal of the NID deduction was to provide for the integration of the corporate and individual income taxes, it seems that the deduction should be limited to the amount of profits earned by the corporation, which could be distributed to the shareholders. That is exactly what the dividend paid deduction method does: it eliminates the effect of the corporate income tax (and, thus, double taxation of the corporate income) by allowing a deduction of the corporate profits distributed as dividends to the shareholders.

The NID rules, in turn, allow the deduction of an amount related to the application of a long-term interest rate over the equity capital of the company without any limitation as to the actual income earned and distributed by the corporation. This means that the NID deductions can be higher than the actual income of the company. Furthermore, the NID rules provide that, if this is the case, the unused NID can be carried forward for seven years to offset future corporate income.

This goes beyond integration. It is an actual deduction for the opportunity costs of the equity capital of the corporation. If the income is lower than such costs, the deduction can be used to shelter future income. It would make sense to allow for this deduction if opportunity costs were actually deductible for individuals in non-corporate investments, which, however, does not seem to be the case. Thus, this characteristic of the NID looks like a tax expenditure for investments in Belgian companies. The value of such expenditure is the present value of the NID accumulated loss, from the year in which it is actually used to offset income.

This is a fundamental difference between the NID and JCP systems. In the Brazilian system, deductions are limited to half of the company's current or accumulated profits. Whereas there is no particular justification for limiting the deduction to half of the profit (instead of all of it), it sure makes sense, if one takes the view that the JCP rules are based on integration grounds, to limit the deduction to the profits.

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3.4.2 Timing of deduction does not match the timing of shareholders' taxation

The second particularity of the NID system is of a more subtle nature. It was explained before that, although the NID deductions refer to a deemed interest on equity capital, the deduction is not matched by the tax treatment of the distributions to the shareholders, which continue to have the nature of dividends. This was not considered to be a problem because such dividend distributions are taxed in Belgium. However, not only the nature of the deduction and payments are not matched, but also their timing. This means that NID deductions can be taken in a particular year regardless of the distribution of the corporate profits to the shareholders.

This leads to the possibility of compounding the amount saved by the deduction with low or no taxation, which is a valuable tax benefit completely unrelated to integration goals. To understand this benefit, one must start considering the effects of distributing or retaining profits in a classical (i.e., non-integrated) system.

In a typical classical system, because dividend distributions do not allow any basis recovery, if the amount of distributed or non-distributed profits increases at the market rate of return, the present value of the tax revenue collected from the future dividend distribution is equal to the value of the tax that would be collected if the distribution was made today. In other words, the time value of the government's tax claim – and hence the effective tax rate – remains constant[75] and there is no actual revenue foregone. Thus, it would make no difference if the government taxes the dividend distributions today or in the future, because the future tax would increase by the market interest rate.

However, this assumption relies on the fact that the individual and corporate income taxes rates are the same. If the rates are different, it makes a difference whether

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[75] See Alvin C. Warren Jr., *Integration of the Individual and Corporate* Taxes, American Law Institute, 1993, pp. 29-30. See also Ethan Yale, *Corporate distributions tax reform: exploring alternatives* (unpublished), pp. 28-29.

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the profits are distributed are not, because in each case the interest would be compounded under different after-tax rates.

This can be illustrated by comparing two scenarios: (i) in the first scenario, the corporate profits would be distributed and would be invested by the individual shareholder, earning market interests, for a certain amount of time; (ii) in the second scenario, the profits would be retained by the corporation, earning the same market interest at the hands of the corporation for the same period of time; after this period, the whole amount (i.e., profits plus interest on it) would be distributed.

The comparison between these scenarios is illustrated on Table 1 below, where *p* is the individual income tax rate, *c* is the corporate income tax rate, *E* is the corporate profit to be distributed, *r* is the interest rate of return and *y* is the period during which the profits are invested.

TABLE 1

TAXATION AND TIMING OF DISTRIBUTIONS IN A CLASSICAL SYSTEM	
DISTRIBUTION	$(1-p)*E*[1+r*(1-p)]^y$
NO DISTRIBUTION	$(1-p)*E*[1+r*(1-c)]^y$

The table shows that, in the distribution scenario, *E* would compound interest over the period *y* at a pre-tax rate of return of *r*, discounted by the individual income tax rate *p* (i.e., after-tax rate of r(1-p)). In the retained profits scenario, *E* would compound interests over the period *y* at an after-tax rate of r(1-p). In both cases, the amount distributed is subject to the individual income tax upon distribution (thus, the (1-p) part of the formula).

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Accordingly, in a classical integration setting, the outcome will be the same if both individual and corporate income tax rates are equal. However, if p>c, there will be an incentive to retain the profits, because they would compound interest at the after-*c*-tax rate of return, which is lower than the after-*p*-tax rate of return. If, however, p<c, there will be an incentive to distribute.

This is a natural outcome of the classical system and incentives to retain or distribute profits will depend on the rate differences[76]. Note that this same outcome would occur in a dividend paid deduction integrated system, where dividend distributions are deducted when made. The deduction of the distribution does not change the fact that: (i) dividends are taxed at *p* rate; and (ii) distributed profits compound interest at a r(1-p) rate and retained profits compound at a r(1-c) rate.

Let us now turn to the NID system. The goal here is to determine whether there is a tax benefit related to allowing the company to take a deduction for the NID and deferring the taxation of the shareholder on the amount deducted. Recall that the net value of the NID deduction is determined by (K*NIDi*c)*(1-p), as mentioned earlier. Thus, it is this portion of the corporate profits (i.e., the portion deducted from the corporate income tax, represented by K*NIDi)[77] onto which the effects of deferral of the distribution must be verified.

To understand these effects, it is also important to determine the tax treatment in a matched setting; that is, in a (hypothetical) system in which taking the NID deduction would automatically mean the taxation of the shareholder. This system would be much like the dividend paid deduction system of integration, since the deduction would be taken when the dividends were actually paid to the shareholders. After taking the deduction, they could be invested by the shareholders earning a r(1-p) return, or reinvested in the corporation, earning r(1-c).

[76] Capital gain taxation may play a role in this case, in favor of the distribution outcome, but we will not analyze it here.
[77] We assume that profits were higher than such deduction; the effects of NID losses are analyzed in item 3.4.1 above

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However, the NID system is different than the dividend paid deduction due to the absence of matching. The allowance of the deduction without any payment made to the shareholders has a different effect over the after-tax rate in which the retained earnings compound. Comparing the retention and distribution scenarios – i.e.: (i) immediate distribution and investment at (pre-tax) rate *r* by the individual shareholder for the period *y*; and (ii) retention by the corporation, which invests at the same rate for the same time, after which it distributes – we would have the results shown in Table 2 below:

TABLE 2

TAXATION AND TIMING OF DISTRIBUTIONS IN NID SYSTEM WITHOUT MATCHING	
DISTRIBUTION	$(1-p)*(K*NIDi*c)*[1+r*(1-p)]^{y}$ or $(1-p)*(K*NIDi*c)*[1+r-(r*p)]^{y}$
NO DISTRIBUTION	$(1-p)*(K*NIDi*c)*[1+r*(1-c)+(c*NIDi)]^{y}$ or $(1-p)*(K*NIDi*c)*\{1+r-[\boldsymbol{c*(r-NIDi)}]\}^{y}$

Table 2 shows that, if distributed, the amount of the NID deduction – whose net value, as mentioned earlier, is (1-p)*(K*NIDi*c) – would compound at the rate *r* discounted by the individual income tax rate *p*: i.e., after tax rate of r(1-p), or, put in another way, r – (r*p). However, if retained, the amount would compound at the rate *r* discounted by the corporate rate *c*, times the difference between the *r* rate and the *NIDi* rate[78].

This happens because, when retained, the amount would compound at the corporate tax rate with the benefit of the NID deduction. The closer the rate of

[78] This is the same as saying that the *r* rate would be discounted by the corporate tax rate (i.e.: r(1-c)) and added by the corporate tax rate times the NID interest rate (i.e.: c*NIDi).

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return *r* is from the *NIDi* rate, the larger the reduction of the corporate income tax rate, and the lesser its discount over the rate *r*. If *r* equals *NIDi*, the amount would compound at the after-tax rate *r*, that is, the corporate income tax would be eliminated. If *r* is lower than *NIDi*, the amount would compound at the rate *r* and an NID loss would be accumulated[79].

In this case, the actual choice between distributing and retaining the profits will depend on the relation between *p* and *c*, and *r* and *NIDi*. The choice would be indifferent if (r*p) equals [c*(r-NIDi)]. If (r*p) is lower than [c*(r-NIDi)], there would be an incentive to distribute. If it is higher, there would be an incentive to retain.

In the cases where he retention of the amount is advantageous, the NID system can be viewed as an actual tax expenditure whose value is the revenue foregone by the NID deduction when compared to a (hypothetical) system where there would be no compounding of interest with the benefits of such NID deduction (that is, a system that matches the NID deduction with the shareholder taxation, such as the dividends paid deduction method).

As mentioned before, this particularity of the NID system does not relate to any goal of integration of the income tax, or to the mitigation of the bias of the tax system towards debt. It seems to be a tax expenditure that stimulates the retention of profits in Belgian corporations. This stimulus does not exist under the Brazilian JCP rules and it looks like unsound tax policy at a first glance. However, such a tax subsidy can be explained when the NID rules are approached as a substitute to the Belgian coordination centers regime – an actual tax expenditure aimed at the attracting of financial activities of multinational groups to Belgium –, as will be explained below.

[79] Note that the formula in Table 2 should not be applied as such if *r* is lower than *NIDi*. In this case, the formula would be just (1-p)*(K*NIDi*c)*$(1+r)^y$ and the unused NID would be carried forward.

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3.5 NID and the Repeal of the Coordination Center Regime

The coordination center regime, enacted in 1982[80], is being phased out from Belgian law after the European Commission successfully attacked it under the EC Treaty's State Aids rules[81]. A coordination center was a Belgian resident company or branch of a non-resident established to perform certain auxiliary activities to the benefit of the group members. If a coordination center was approved by a Royal Decree, it could qualify for a special tax treatment that would basically exclude interest rates' spread income from taxation. Thus, coordination centers could concede loans to foreign companies of the group and not be taxed on the interests[82]. They were an attractive option for multinational groups to establish in Belgium a financial company that would grant loans for the rest of the group.

Due to the fact that the coordination center tax regime was not a general measure available to any corporation, it was challenged under the European State Aids rules. With its repeal, Belgium would stop being an attractive jurisdiction for financial holdings of multinational groups. The solution was to tailor rules that would not violate the State Aid provisions, but still allow for a beneficial regime for financial centers. The NID rules fulfill this purpose and because they apply to all Belgian entities it is harder to qualify them as a specific subsidy under the State Aid provisions.

After the NID rules, any Belgian company can take over the activities of a coordination center. Such company would be capitalized through equity and provide intragroup loans. The interests' income derived from such loans would be compensated, to a certain extent, by the NID. For example, it could grants loans at

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[80] See Axel Haelterman, Henk Verstraete, op cit, p. 363.
[81] Jacques Malherbe, op cit, p. 79, footnote 23, citing the Decision of February 17, 2003 (2003/755/EC), O.J.L. 282, October 30, 2003, p. 25. Also, ECJ cases C-399/03 and joint cases C-182/03 and C-217/03 confirming the State Aid nature of the coordination centers rules, but allowing a transitory period up to 2010. See J. Malherbe and M. Wathelet, Pending Cases involving Belgium : The Belgian Coordination Centers Cases, in M. Lang, J. Schuch and Cl. Staringer, ECJ-Recent Developments in Direct Taxation, Eucotax, Vienna, Linde, 2006, p. 31.
[82] See Jacques Malherbe, op cit, pp. 79-81; Axel Haelterman, Henk Verstraete, op cit, p. 363.

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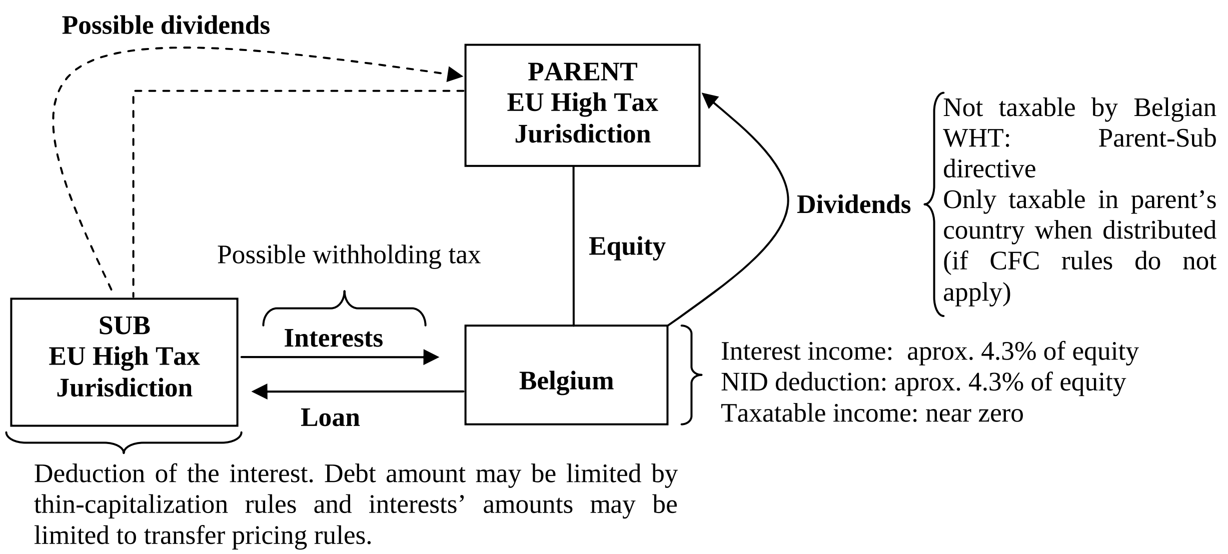
a 4.473% rate and take a 4.307% deduction on its capital in 2009, leaving only 0.027% to Belgian taxation[83].

Given the fact that the NID applies regardless of any dividend distribution or any other sort of shareholder taxation, the Belgian company's (almost) tax free profits could be retained and reinvested. Moreover, given the Parent-Subsidiary directive, dividend distributions by the Belgian company to a corporate parent in an EU Member State would not be subject to tax in Belgium. Thus, the NID provisions may allow some international tax arbitrage opportunities. Figure 1 below shows a setting where a Belgian company can be used to finance other European companies of a multinational group:

FIGURE 1



This structure allows for the interest deduction to reduce the taxable income in the subsidiary's country, assuming that such deduction would be within the limits of thin-capitalization or transfer pricing rules of the subsidiary's country. If the interests' payments to Belgium are not taxed at source, or if source taxation is

[83] See. Axel Haelterman, Henk Verstraete, op cit, p 363. The authors also mention that practice shows that many of the groups that used a Belgian coordination center now use a Belgian company with the application of the NID. The rate for SME's is increased by 0.5 %.

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withheld at a rate lower than the corporate income tax saved, the interests' payments will generate a tax advantage at the subsidiary's country.

The Belgian company's interest income, on its turn, will be matched by the NID, so very low (or none) income tax will be due in Belgium. Dividend distributions from the Belgian company will not be taxed in Belgium under the Parent-Subsidiary Directive. The parent's country will probably tax the dividends distributed by the Belgian corporation, granting a foreign income tax credit for the income tax paid in Belgium, if any. However, it should be noted that because the NID applies regardless of any distribution, the Belgian company does not necessarily need to distribute its profits. If the parent's country CFC rules do not apply, the taxation of such profits can be deferred and they can be reinvested by the Belgian company, compounding interests at a favorable after tax rate because of the NID (see item 3.4.2 supra). Moreover, if the Belgian NID is superior to the interest income, such deduction can be used to shelter other types of income of the Belgian company.

The main advantage of this structure, when compared to the direct equity capitalization of the subsidiary by the parent, is the possibility of the interest deduction in the subsidiary's country. Of course, this result could be achieved by the direct debt capitalization of the subsidiary by the parent. However, without the interposition of the Belgian company, interests paid by the subsidiary would immediately be taxed at the parent's country. In the structure using the Belgian company, as the NIDs do not depend on any distribution, the Belgian company's profits could be retained in Belgium and be reinvested, compounding interest with very low (or no) tax and deferring taxation in the parent's country, as long as no CFC rules apply.

This deferral, as demonstrated in item 3.4.2 supra, is the true tax expenditure aspect of the NID rules. Of course, if we are dealing with a fully operational Belgian company, with Belgian resident shareholders, this tax expenditure (i.e., the deferral) has a budgetary cost to Belgium. However, if we are dealing with a Belgian corporation, owned by a foreign EU-company, that is used only as a center to debt-

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finance the activities of other foreign companies of the group, the picture is different. The Belgian company would never exist if not for the NID provisions, because the debt capitalization of the subsidiary would be made directly by the parent. With the Belgian company using the NID provisions, however, the interest income that would otherwise be immediately taxable in the parent's country is received by the Belgian company and its taxation is deferred until the moment of the dividend distribution. The true revenue forgone, in this case, is from the parent's country and not really by Belgium. Thus, the tax benefit supposedly given by Belgium is coming out of someone else's pocket.

The NID rules allow, in this sense, Belgium to become the jurisdiction of choice to centralize the debt financing activities of European operations of multinational groups. They cost more to Belgium than the coordination center regime, because the latter was tailored specifically for the sort of foreign operation described above, while the NID rules allow for all Belgian companies (even those that operate only inside Belgium) to have a tax benefit. This more general aspect of the NID rules is exactly what allegedly makes them bulletproof to the State Aid provisions of the EC Treaty; the extra revenue cost, when compared to the coordination center regime, is the price for that.

What is in it for Belgium? Well, as any tax haven knows, capital flows themselves bring some money and jobs to the country. Moreover, Belgium can still collect some tax on the income represented by the positive difference between the NID and the interest income that the companies have.

The structure summarized in Figure 1 above is just one possible alternative that may take advantage of the NID provisions in an international setting. One must not forget that the parallel use of the Belgian tax treaties network may also bring favorable tax outcomes, when structured together with the use of the NID rules[84].

[84] Law and accounting firms have issued memos marketing such possibilities. See: http://www.altassets.com/casefor/countries/2008/nz13482.php;

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Moreover, other Belgian tax provisions, such as the patent income deduction[85], may be used in conjunction with the NID rules to bring favorable tax results[86].

It is yet to be seen if European Member-States, or the Commission, will be able to take action against the Belgian NID rules. It seems that the State Aid rules do not cover them, due the fact that they apply to all Belgian corporate taxpayers (and not only to specific types of companies, as did the coordination center regime). It is hard to identify any *de jure* ring-fencing in the NID rules, although there may be a *de facto* ring-fencing, as the rules are tailored to disproportionately benefit the tax treatment of multinationals' financial centers of established in Belgium.

Without the State Aid rules, the alternative would be for Member-States to impose CFC rules as to the profits retained in Belgian companies that make use of the NID regime. However, due to the restrictive interpretation of the European Court of Justice[87], the possibilities under which CFC rules can be applied in the European context are narrow and European countries might not be able to use these rules against the Belgian regime.

4. Conclusions drawn from the comparative analysis

The comparative analysis done above shows that, despite some resemblances in the policies and the mechanisms of the JCP and NID rules, they have fundamental differences.

The Brazilian JCP rules were enacted to correct a distortion that would be caused by the repeal of the financial statement's inflation adjustments during the Real Plan and the bias that the Brazilian system would have towards debt capitalization. It can

[85] The patent income deduction rule allows the deduction of 80% of the patent income. If a Belgian company capitalizes the patent (thus increasing the NID deduction basis) and earns patent income, the taxation can be indeed low.

[86] This possibility is already being marketed as a planning option. See http://springael.com/Documents/NID_BB_20080601.pdf.

[87] See, among others, C-196/04, Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue.

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be viewed as a special kind of dividend paid deduction integration method, parallel to the dividend exemption method adopted by Brazilian law. As such, it allows for the requalification of part of the Brazilian companies' distributed profits as interests paid over its own capital. Such requalification allows for the deduction of the amounts paid by the corporation and a matching taxation of the shareholders at the favorable rate that applies to interests received by individual bondholders.

Given the Brazilian integration policy and the sole goal of the JCP rules to balance the treatment between equity and debt, such rules should not be viewed as tax expenditures, but as part of the Brazilian benchmark tax system.

The NID rules can also be pictured as a mechanism tailored to correct the bias that the Belgian income tax system creates in favor of debt capitalization over equity. Thus, it is a step towards integration.

However, the NID rules go further from the integration goal and provide for tax benefits that are unrelated to income tax integration policy goals. Such benefits derive from the fact that: (i) NID deductions are not limited to the company's profits and can lead to a loss carryover; and (ii) the timing of the NID deductions is not matched with the shareholders' taxation.

These particularities of the NID system, which look awkward in light of the integration policy goal, start making sense when one realizes that the NID rules were enacted after the Belgian coordination center regime was challenged under the State Aid rules of the EC Treaty and, thus, progressively repealed. The particularities of the NID rules make them a good substitute for the coordination center regime, with the advantage of the unlikely possibility of it being challenged under the State Aid rules.

This last policy goal explains the most fundamental differences between the Brazilian JCP rules and the Belgian NID system. The latter is actually a tax expenditure in regard to some of its effects, while the former is not.

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One might wonder if there was any influence of the Brazilian system over the tailoring of the Belgian NID system. This hypothesis seemed plausible considering that the NID system was enacted after Ambev, a Brazilian brewing conglomerate, merged with Interbrew, a Belgian brewing company, forming a company called InBev. One could wonder if the chairs in InBev's board had anything to do with the lobbying for the Belgian NID rules. We have found no concrete evidence of that. Moreover, given the differences between the rules and the policy goals underlying them, the correlation seems unlikely.

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