



**Merchant Banking
Corporate & Institutional Banking**

The Notional Interest Deduction New Opportunities for Investing in Belgium

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1. Belgium, “the place to be”

It isn't only lovers of chocolate, beer and comic strips who tend to favour Belgium. For decades, it has prospered as a modern, technologically advanced nation, at the crossroads of a geographical zone of more than 230 million people that also includes the United Kingdom, Germany, France, the Netherlands and Luxembourg.

This densely populated country (10 million inhabitants) is one of the founding members of the European Union, and its capital, Brussels, is also the capital of the EU. At the heart of Europe's political and economic decision-making, Brussels houses two vital European institutions: the Council of Ministers and the Commission.

Belgium has succeeded in drawing in many other institutions and businesses: NATO has its headquarters on Belgian territory, and many multinational companies have set up head offices, co-ordination and distribution centres and holding companies here. With its highly developed research parks, the country has also emerged as a favourite location for the R&D activities of bio-pharmaceutical groups.

Belgium holds several enviable world records: for per capita exports, high productivity and low poverty, for example. It also offers exceptionally high living standards and plays host to many highly-qualified expatriates, who enjoy a favourable special tax regime and excellent international school facilities.

The country benefits from a modern and highly efficient infrastructure, with high-speed train links giving quick and easy access to major European financial centres – Paris is just 1 hour 25 minutes away, while the trip to London will soon take less than 2 hours. Other high-speed train links to the Netherlands (Rotterdam/Amsterdam) and Germany (Köln/Frankfurt) are currently being built. Belgium also has an extensive motorway network and several airports with daily direct flights to the United States.

Its multi-lingual culture, modern telecommunication systems and efficient banking facilities have all helped Belgium become a leading international financial marketplace. The official currency is the euro. Euronext, the first cross-border exchange in Europe, was born in 2000 from the merger of the Brussels Stock Exchange with those of Amsterdam and Paris. The Lisbon Stock Exchange joined Euronext in 2002.

Reflecting Belgium's status as a financial centre, Belgian law provides for several legal and tax measures to encourage foreign investments. From 1 January 2006 these will include the concept of “Notional Interest Deduction”, which allows for a tax deduction for the cost of capital and will apply to both Belgian and foreign companies with a taxable presence in Belgium. At the same time, the 0.5% registration duty on capital contributions (so-called “capital tax”) will be abolished, drastically reducing the cost of equity investing in Belgium.

2. Overview of the Belgian corporate tax and legal regime

When incorporating a company in Belgium, the most commonly used legal forms are the public limited liability company (société anonyme/naamloze vennootschap) and the private limited liability company (société privée à responsabilité limitée/besloten vennootschap met beperkte aansprakelijkheid). Both legal forms require a minimum capital sum to be subscribed by the company's shareholders, amounting respectively to EUR 61,500 and EUR 18,550. A public limited liability company must be set up by at least two shareholders, and needs to be managed by at least three directors (two managers may suffice under certain circumstances). A private limited liability company may be set up by one shareholder and managed by one director.

Belgian corporate tax is levied at a rate of 33%, increased by a 3% "crisis surcharge" to an overall 33.99% rate. A progressive scale of reduced rates applies under certain specific conditions to small companies.

Generally speaking, Belgian corporate tax is levied on the basis of the accounting result as shown in the statutory accounts of the Belgian company. But there are certain exceptions to this, the most noteworthy concerning the treatment of income, gains and losses arising from shares. Indeed, income and gains derived from shares benefit, under certain conditions, from the participation exemption regime, while losses realised on shares are treated as not tax deductible (except, to a certain extent, when incurred upon liquidation of the company in which the shares are held).

As a general rule, Belgian domestic tax law requires withholding tax to be levied on interest and dividend income paid or attributed by a Belgian company. The rates applicable are respectively 15% and 15%/25%. However, many exemptions exist. Moreover, companies having their tax residence in Belgium may also invoke the double-tax treaties concluded by Belgium, as well as provisions contained in EU directives such as the Parent-Subsidiary Directive and the Interest and Royalty Directive.

The standard VAT rate is 21%. However, several exemptions apply. For instance, most banking and financial activities, as well as transactions relating to shares, are exempt from VAT.

3. A business-friendly tax environment for intra-group financial activities

Aware of the importance of creating a business-friendly financial environment in Belgium, the Belgian legislator has progressively introduced a framework of tax measures that aim at encouraging companies to locate and develop their intra-group financial activities on Belgian territory.

Since the 1980s, Belgium has been a well-known host country for corporate co-ordination centres. These are typically highly capitalised entities, performing intra-group financial services and providing intra-group funding. They are taxed on a cost-plus basis, with other benefits including exemption from withholding tax on the interest, dividends and royalties they pay and exemption from registration duty. Although these centres are being “rolled back” on the basis of European-level decisions, the Notional Interest Deduction is, as explained below, expected to give a new stimulus to this type of activity, and will complement existing favourable provisions.

These provisions comprise the following:

- Belgian tax law does not require any withholding tax to be levied for interest paid by “financial enterprises” (i.e. intra-group treasury or financial centres), nor for interest paid by a Belgian company (or a Belgian branch) to a bank established in the EEA or in a country with which Belgium has a tax treaty (approximately 75 countries).
- Provisions provided for by the European Interest and Royalty Directive have been translated into Belgian domestic tax law in a very liberal way, resulting in exemption from Belgian withholding tax on interest and royalty payments to associated companies located within the EU.
- The Parent–Subsidiary directive has also been translated into Belgian law, resulting in exemption from Belgian withholding tax on dividend payments to parent companies located within the EU.
- Belgium appears to be an ideal location for mixed holding companies. This results from the availability of a participation exemption regime for income and gains derived from shares (dividend received deduction and net capital gains tax exemption), cumulated with the possibility to receive a deduction for interest relating to loans taken for the purpose of the acquisition of shares. Moreover, except in very specific circumstances, Belgium has no “thin-capitalisation” rules (i.e. no required debt-equity ratio from a Belgian tax viewpoint).
- Belgium has a broad tax treaty network. This includes the first tax treaty signed with Hong Kong, which allows, under certain threshold conditions, a repatriation of funds without any withholding tax.
- Belgium has a well-established ruling practice as regards tax legislation, providing Belgian taxpayers with up-front legal certainty regarding the possible tax consequences of planned transactions or investments.

Beside the financially orientated tax provisions listed above, other fiscal measures such as investment tax deductions and accelerated tax depreciation, as well as a very beneficial expatriate tax regime, have also played a role in giving Belgium a competitive advantage compared with other EU countries.

The Notional Interest Deduction regime is based on the observation that many tax regimes still discriminate between debt and capital funding. This is due to interest being tax deductible on the part of the paying company, while the cost of capital (distributed dividends) is not.

The new regime will limit this distinction, by reducing the difference in tax treatment between debt funding and equity funding. Soon, not only actual interest on debt will be tax deductible, but also a risk-free interest equivalent calculated on the basis of a company's equity.

This deduction forms part of the normal Belgian income tax regime and is therefore available to companies subject to Belgium's corporate income tax or to the country's non-resident income tax regime. It is effective as from assessment year 2007 (i.e. financial years ending on or after 31 December 2006).

Since the deduction applies to all Belgian companies and branches established in Belgium (with a few limited exceptions) it should in principle not be considered as state aid, nor as harmful tax practice from a EU viewpoint.

Last but not least, the Belgian authorities have decided to abolish the 0.5% registration duty ("capital tax") on capital contributions (or increases in share capital), effective as of 1 January 2006. This will enable a significant reduction in the costs of equity investing in Belgium.

4. Main features of the Notional Interest Deduction

The Notional Interest Deduction is a deduction from taxable income determined according to the following formula:

$(\text{Equity} - \text{Exclusions}) * \text{Belgian Risk-Free Rate}$

where:

- Equity is the equity of the company as in the stand-alone financial accounts based on Belgian GAAP. It includes a company's share capital, share premiums, reserves, retained earnings and carried-forward profits, but excludes re-evaluation capital gains and capital subsidies.
- Exclusions comprise adjustments made to the amount of equity in order to avoid a "domino" application of the Notional Interest Deduction and other forms of abuse. For financial services business, the most relevant exclusions are:
 - the fiscal net value of the own shares a company holds in its own share capital;
 - the fiscal net value of shareholdings and shares that are financial fixed assets;
 - the fiscal net value of shares in investment companies, the dividends from which would qualify for the Dividend Received Deduction.
- The Risk-Free Rate refers to the average interest rate on Belgian 10-year Government bonds. For tax assessment year 2007 (i.e. financial years ending on or after 31 December 2006, the first financial year to which the Notional Interest Deduction applies), the reference rate is equal to the average 10-year risk-free interest rate (the so-called "OLO" rate) for the year 2005. This is estimated to be around 3.5% for 2006. Small companies will be allowed to apply a rate increased by 0.5%.

In principle and subject to exceptions, the excess Notional Interest Deduction that remains unused for a given year (in case of insufficient taxable income) can be carried forward for the next seven years.

Example

Example without and with Notional Interest Deduction

	Without Notional Interest Deduction	With Notional Interest Deduction
Assumptions	Equity: 100 Qualifying assets: 100 10 year OLO: 3.5%	
Taxable profit	5	5
Notional Interest Deduction	(0)	(3.5)
Taxable basis	5	1.5
Corporate tax (33.99%)	1.7	0.5
Net profit	3.3	4.5
Effective tax rate	33.99%	10%

Source: Fortis Bank

As shown in the example above, the Notional Interest Deduction will allow Belgian companies to drastically reduce their effective tax rate, to the extent that they are sufficiently financed with equity.

5. Efficient use of the Notional Interest Deduction regime: some examples

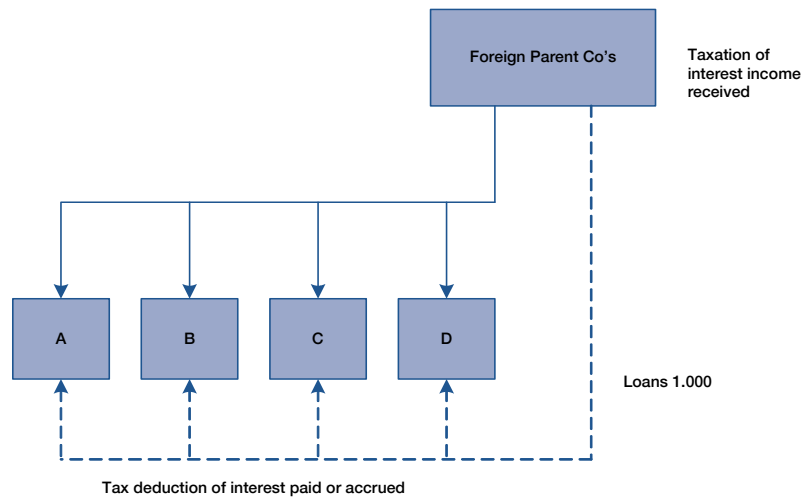
The tax planning ideas outlined below are based on the Notional Interest Deduction regime, and illustrate how multinational groups may be able to optimise their overall effective tax rates.

5.1. Setting up a finance company in Belgium

As from 1 January 2006, it will be possible to use a Belgium-located company (Bel Co) as a group finance vehicle, without any need to apply for a special tax regime with the Belgian tax authorities (if need be, a ruling may be requested concerning the remuneration to be granted to Bel Co for its finance activities).

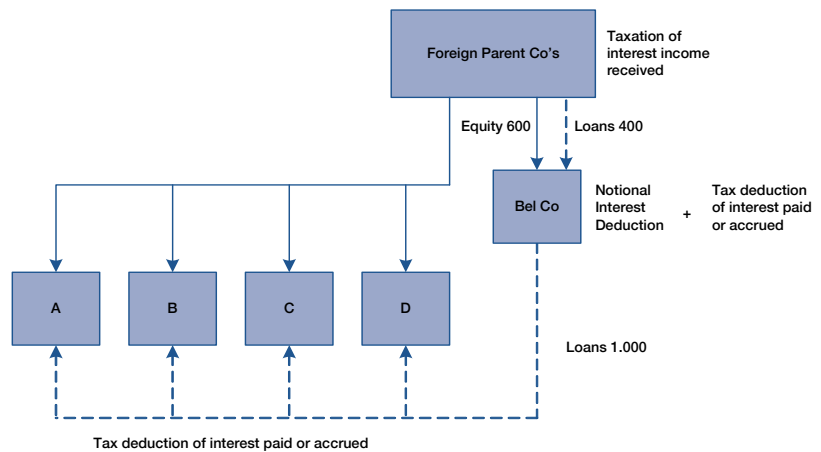
Depending on the amount of capital contributed by the shareholders of Bel Co (without any capital duty being due upon such contribution), these shareholders will be able to offset part of the interest income arising from the loans granted to the other group companies, by means of the Notional Interest Deduction. There will thus be opportunities to reduce the effective tax rate applicable to the interest income received by the finance group company, while the same interest will in principle be tax-deductible on the part of the paying group entities (subject to the local tax deduction rules of the countries where these entities are situated).

Before 1 January 2006



Source: Fortis Bank

As from 1 January 2006



Source: Fortis Bank

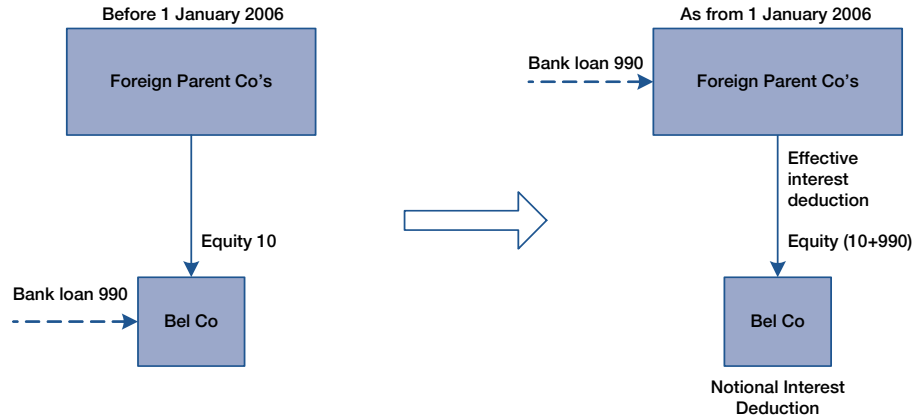
Also worth noting in the example above is that dividend income can be distributed by Bel Co to its EU parent companies without any Belgian withholding tax being due, provided that each such company has held a minimum 20% stake of Bel Co for at least one year. Nor does withholding tax apply to dividend distributed to parent companies located in Hong Kong, on condition that a 25% holding has been kept in the Belgian subsidiary for at least one year. This undoubtedly makes Belgium an ideal gateway from Asia into Europe.

Dividend distributed by a Belgian company to US-located parent companies, is subject to a 5% withholding tax when at least 10% is held in that Belgian company (and to a 15% withholding tax otherwise).

Finally, interest income paid by Bel Co is subject to a 15% withholding tax. However, as outlined above, several exemptions are available, including those provided by the EU Interest and Royalty Directive and by the general domestic exemption for “financial enterprises”.

5.2. Optimising location of external loans

As from 1 January 2006, external loans taken by a Belgian company (Bel Co) can be replaced by equity provided by their foreign corporate shareholders (Foreign Parent Co's), which can in turn fund themselves through external financing. Subject to local tax deduction rules in the foreign investors' countries of residence, this re-allocation of external financing within the group may allow for the creation of a "double dip", consisting of an effective interest deduction at the level of the foreign corporate shareholders, coupled with a Notional Interest Deduction at the level of the Belgian subsidiary.

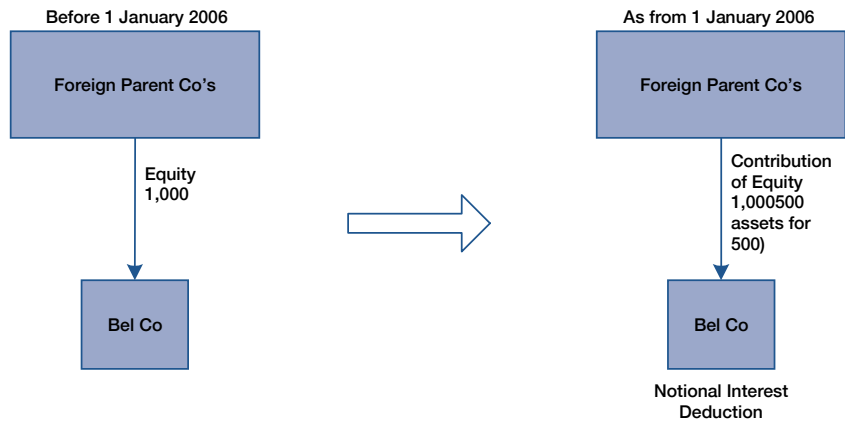


Source: Fortis Bank

5.3. Optimising location of assets

As from 1 January 2006, foreign corporate investors (Foreign Parent Co's) will be able to contribute their profitable assets to their Belgian subsidiary without any capital duty. Moreover, this may enable a reduction of the taxable profit of the parent companies, while the additional profit located at the level of the Belgian subsidiary would be (partly) offset by the Notional Interest Deduction, thus reducing the overall effective tax rate of the group.

Avant 1er janvier



Source: Fortis Bank

The same reasoning is applicable to new activities to be launched that require significant investments (e.g. R&D activities).

6. Contacts

Philippe Coosemans
Tax Merchant Banking
Fortis Bank
Tel: +32 2 565 67 42
philippe.coosemans@fortisbank.com

Frédéric Fontaine
Corporate Finance & Capital Markets
Fortis Bank
Tel: 32 2 565 55 40
frederic.fontaine@fortisbank.com

Damien Vanderborght
Merchant Banking
Fortis Bank
Tel: 32 2 565 64 22
damien.vanderborght@fortisbank.com

Herman Coppens
Managing Director
MeesPierson Intertrust
Tel: 32 2 209 22 05
Herman.coppens@meespiersonintertrust.com

Sandrine Sas
MeesPierson Intertrust
Tel: 32 2 209 22 00
sandrine.sas@meespiersonintertrust.com