

Belgian Court Approves Differing Tax Treatment of Full, Partial Repayment of Share Capital

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The Belgian Constitutional Court has ruled that differing tax treatment of full and partial repayments of share capital is not discriminatory, as both situations clearly have different consequences.

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The Belgian Constitutional Court, in its June 20 judgment in case 91/2007, ruled that differing tax treatment of full and partial repayments of share capital is not discriminatory. The Court of Appeal of Ghent had asked the Constitutional Court whether an exemption from dividend withholding tax is discriminatory because it applies only to full repayments of capital, excluding partial repayments. The Constitutional Court held that there is no discrimination, as both situations clearly have different consequences.

Background

In the event of the full distribution of a company's capital as a result of its dissolution or for any other reason, any amounts distributed in excess of the company's paid-up share capital are deemed to be dividends under article 209 of the Belgian Income Tax Code (BITC). In 1995 those dividends benefited from a withholding tax exemption by virtue of article 264, section 1.2 of the BITC. Today, however, those dividends are subject to a 10 percent dividend withholding tax.

During 1995 a Belgian company (the taxpayer) decided to reduce its share capital by repaying a substantial portion to its shareholders. The taxpayer did not apply any withholding tax, assuming that the aforementioned exemption applied to partial repayments of capital (capital reductions). The Belgian tax authorities disagreed, stating that the withholding tax exemption applied only to a full repayment of capital -- that is, the dissolution of the company.

Appearing before the Court of Appeal of Ghent, the taxpayer argued that the term "any other reason" in article 209 BITC refers to partial repayments of capital and that the Belgian tax authorities were therefore not entitled to impose withholding tax. The appeals court disagreed, saying that it follows from both case law and the legislative history of the applicable legal provisions that the exemption applies only to full repayments of capital.

A second line of defense prompted the appeals court to ask the Constitutional Court's opinion about the compatibility of the dividend withholding tax exemption of article 264, section 1.2 BITC with the equal treatment and nondiscrimination principle contained in articles 10 and 11 of the Belgian Constitution.

Decision of the Constitutional Court

The Constitutional Court rejected the discrimination argument, stating that the consequences of a full repayment of capital differ from those of a partial repayment. The court said the full

distribution of a company's share capital terminates the participation of the shareholders in the company's risks and restricts the company's ability to undertake legal and juridical action. Conversely, a capital reduction does not have such consequences: The company is not dissolved and the shareholders continue to participate in the profits and losses realized by the company despite that the participation of the shareholders in the company's risks is reduced proportionally.

Such essential differences justify different tax treatments of the shareholders. Hence, the exemption contained in article 264, section 1.2 BITC, in conjunction with article 209 BITC, does not violate the equal treatment and nondiscrimination principle.

Comments

Until 2002, liquidation proceeds resulting from either the full distribution of a company's capital as a result of a dissolution (article 209 BITC) or the partial distribution as a result of the death, retirement, or exclusion of one of the partners (article 187) were exempt from dividend withholding tax (article 264, section 1.2). A mere capital reduction does not fall within the scope of either exemption and is, therefore, subject to dividend withholding tax, unless the capital reduction relates only to the effectively paid-up share capital and complies with the provisions of Belgian company law related to the reduction of share capital, in which case the repaid share capital is not treated as a dividend (article 18, section 1.2). Hence, the tax authorities rightly refused to allow the exemption.

In turn, the Constitutional Court correctly decided that the different tax treatment does not violate the equal treatment and nondiscrimination principle contained in articles 10 and 11 of the Belgian Constitution. In view of the clearly different consequences of a capital reduction and a capital distribution in the event of a liquidation, equal treatment would violate the constitution.

The decision also is in accordance with other case law of the Constitutional Court confirming the admissibility of differing tax treatments in situations related to a capital distribution on the liquidation of a company on the one hand and mere capital reductions on the other hand (judgment 84/99 of July 15, 1999).

The practical consequences of the judgment are limited. Regarding liquidation proceeds, the exemption of article 264, section 1.2 BITC was abolished as of 2002 (article 15 of the Law of December 24, 2002). As a matter of principle, liquidation proceeds now are subject to a 10 percent withholding tax regardless of the circumstances under which the distribution occurs and regardless of the full or partial repayment of the company's capital (article 269, section 1.2 *bis* BITC).

The withholding tax was introduced with the goal of increasing the coherence of the tax system. Until 2002, shareholders of an operational company were taxed in the event of a capital reduction, whereas shareholders of a liquidated company benefited from an exemption.

That the withholding tax on liquidation proceeds is lower than the tax on ordinary dividend distributions (10 percent versus 25 percent or 15 percent) is not considered a violation of the constitutional principle of equal treatment and nondiscrimination. The legislative history refers to the Constitutional Court's judgment of July 15, 1999, to justify the lower withholding tax rate on liquidation proceeds. The June 20 judgment merely confirms the admissibility of the lower

rate.

Furthermore, if a Belgian company wants to distribute part of its retained earnings to its shareholders with a 10 percent withholding tax (instead of the 15 percent or 25 percent rate), it can consider buying back its own stock. The distribution of retained earnings under a buyback of stock is also subject to the 10 percent withholding tax rate.

The relevance of paying a lower rate of dividend withholding tax typically is that in a cross-border situation, there is not always a bilateral tax treaty reducing the rate of withholding tax to 10 percent or less. In a Belgian national context, the relevance is that for individual shareholders, the interest withholding tax is the only and final income tax; hence, 10 percent is a more attractive rate for the shareholders than 15 percent or 25 percent.

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