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GENERAL AGREEMENT ON TARIFFS AND TRADE

INCOME TAX PRACTICES MAINTAINED BY BELGIUM

Report of the Panel

1. The Panel's terms of reference were established by the Council on 30 July 1973 (C/M/89 paragraph 7):

> "To examine the matter referred by the United States to the CONTRACTING PARTIES pursuant to paragraph 2 of Article XXIII, relating to income tax practices maintained by Belgium and to make such findings as will assist the CONTRACTING PARTIES in making the recommendations or rulings provided for in paragraph 2 of Article XXIII."

2. The Chairman of the Council informed the Council of the agreed composition of the Panel on 17 February 1976 (C/M/112, paragraph 17):

Chairman: Mr. L.J. Mariadason (Counsellor, Permanent Mission of Sri Lanka, Geneva)

Members: Mr. W. Falconer (Director of Trade Policy, Department of Trade and Industry, Wellington)

Mr. F. Forte (Professor of Public Finance, University of Turin)

Mr. T. Gabrielsson (Counsellor of Embassy, Permanent Delegation of Sweden to the European Communities, Brussels)

Mr. A.R. Prest (Professor of Economics of the Public Sector, London School of Economics)

3. In the course of its work the Panel held consultations with the United States and Belgium. Background arguments and relevant information submitted by both parties, their replies to questions put by the Panel as well as all relevant GATT documentation served as a basis for the examination of the matter.

4. The Panel met on 16-18 March, 28 June-1 July and 26-30 July 1976 and concluded its report through a postal procedure.

5. The United States requested the Panel to find that the tax practices of Belgium violated Article XVI:4 and that there was therefore a prima facie case that these practices were nullifying or impairing benefits accruing to it under the General Agreement.

6. The United States also suggested that the four complaints on the DISC legislation and income tax practices in France, Belgium and the Netherlands should be considered together because they raised the same principles concerning the application of the GATT.

Factual aspects of the practices in question

7. The following is a brief factual description of the tax practices complained of by the United States as the Panel understood them.

8. The Belgium income tax system is based on the principle of world-wide taxation of residents and on the source principle as far as taxation of non-residents is concerned.

9. Therefore, non-residents are only taxed in Belgium on income obtained or collected by them there. Profits of foreign subsidiaries of Belgium-based corporations are not taxed by Belgian authorities, but are subject to the tax jurisdiction of the foreign country in question.

10. In order to avoid double taxation of sales effected abroad by foreign sales establishments Belgium introduced the principle of tax relief in 1906; the measure was subsequently carried into law in 1919, when income tax was established in Belgium.

11. Income obtained from foreign establishments by resident corporations and which has been taxed abroad is assessed after deduction of foreign tax. Belgian tax is then applied to it at one quarter of the normal rate. Evidence that the profits are both obtained and taxed abroad must be produced. In practice, evidence of foreign taxation is not required in respect of profits obtained through an establishment located abroad, if it draws up separate accounts. The fact that certain constituent elements of income may not be taxable or may be tax free in the foreign country is not generally sufficient justification for refusing to grant the benefit of Belgian tax reliefs.

12. As far as sales through foreign sales subsidiaries (permanent equity holdings) are concerned, Belgian taxes foreign profits therefrom only to the degree that they are actually distributed to the parent corporation. However, in order to remedy the effects of cascading taxation of dividends, dividends derived from subsidiaries which would normally have been taxed are deducted from the tax base of the recipient to the extent of 95 per cent (or 90 per cent for certain holding companies) of the net amount received, grossed up by a deemed movable prepayment of 5 per cent; this system is applicable regardless of the size of the Belgian corporation's equity holding generating dividends.

13. A provision in Belgium's Income Tax Code (Article 24), which is of general scope, lays down that transactions between Belgian enterprises directly or indirectly related to an enterprise established abroad shall be governed by the arm's-length principle. The administration is given much latitude in its application of this provision.

Main arguments

A. Article XVI:4

14. The representative of the United States recalled that Article XVI:4 prohibited the use of export subsidies, that Belgium had signed the Declaration giving effect to that paragraph and that Belgium therefore had an obligation not to grant subsidies which led to the "sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." He also recalled that the illustrative list of measures to be considered as subsidies in the sense of Article XVI:4, which was proposed by France, included the following items: (c) "The remission, calculated in relation to exports, of direct taxes ... on industrial or commercial enterprises" and (d) "The exemption, in respect of exported goods, of ... taxes, other than ... indirect taxes levied at one or several stages on the same goods if sold for internal consumption ...".

Effects of the territoriality principle as applied by Belgium for taxation of foreign profits

15. The representative of the United States argued that Belgium, at least in practice, followed the territoriality principle of taxation and, as a result, did not tax the export sales income of foreign branches or subsidiaries of their domestic manufacturing firms. Taxes on such income were for the most part permanently forgiven rather than merely deferred. This system of remitting or exempting taxation of profits from export sales by foreign branches or subsidiaries created a distortion in conditions of international competition in that it afforded

remission or exemption of direct taxes in violation of Belgium's commitment as a contracting party under Article XVI:4. The relative tax burden on the sale of products for export as against domestic sales was lower as a result of the remission of taxes on a portion of export sales income.

16. The representative of the United States pointed out that although the net amount of foreign income of resident corporations was included in the tax base, Belgian tax on this portion of the income was reduced by 75 per cent if this income was both generated and taxed abroad. Income was considered to be generated abroad if the activity which produced the income was carried out through a permanent establishment, and income was considered to be taxed abroad if subject to regular taxation in that country, even if the income was exempted by that country through special rules. He concluded that the application of the reduced rate amounted to an exemption or remission on that part of the profits which was permanent and could be freely used by the domestic manufacturing firm. In addition, he pointed out that generally, under tax treaties, the income realized through a permanent establishment in the other country was exempt even from the reduced rate of Belgian tax.

17. The representative of the United States further argued that, by organizing a foreign branch or subsidiary in a low-tax country, a Belgian manufacturing firm could enjoy the low-tax rate on that portion of the total export sales income which was allocated to the foreign branch or foreign sales subsidiary, that the amount of export sales income allocated to foreign sources was generally substantial and that under the Belgian system the right to tax foreign income was given up. He concluded that as a minimum the sales element of export earnings was exempt from taxation and therefore subsidized in violation of Article XVI:4.

18. In reply, the representative of Belgium stated that Belgian law did not contain any provisions designed to encourage export operations. Export corporations did not receive any tax relief that was not extended to Belgian corporations in general. The tax results of a corporation exporting goods were not different from the tax results of a domestic sale. If export sales were effected from an establishment or even a subsidiary that was Belgian, the sales profit was treated like Belgian-source income and was taxed at the full rate.

19. The representative of Belgium went on to state that there was no exemption in favour of foreign agencies or branches of Belgian companies engaged in exporting, as the profits were incorporated in the profits taxable in Belgium. The reduction to one quarter of the normal tax rate took place only if the taxpayer produced evidence that the profits had been obtained and taxed abroad through a branch or otherwise. Moreover, because of the ceiling in this provision, it could never bring complete exemption from Belgian tax. International double taxation could

therefore only be avoided as a result of a convention. The statement that under tax treaties the income was not taxed by Belgium at all completely disregarded the fact that the objective pursued by all States concluding such treaties was to eliminate double taxation that could occur in clearly defined situations; and the statement took no account of the taxes that normally had to be paid in the host country. As a general rule, these countries made broad use of their taxation powers.

20. The representative of Belgium said that, in order to combat abusive use of tax havens or of countries with very moderate taxes, Belgium had very stringent provisions as a result of which Belgian corporations tempted to use tax havens placed themselves in a more difficult position than other taxpayers, in particular as regards the burden of proof that their claims were justified.

21. The representative of Belgium added that Belgium had introduced the principle of tax relief in 1906, and that the measure had subsequently been carried into law in 1919. He noted that, although its system of a flat rate reduction in respect of profits of branches had been known for a long time, the United States did not challenge it in GATT until the European Communities made a complaint about the DISC legislation.

22. Commenting on this reply, the representative of the United States argued that it was the effect and not the intent of the legislation which was important. The fact that the practices of Belgium had been in operation for several years was irrelevant. The language of the 1955 amendments to the General Agreement (which, inter alia, introduced paragraph 4 of Article XVI), and the 1960 Declaration giving effect to Article XVI:4 as well as the Standstill Declaration made it absolutely clear that the contracting parties adhering to the 1960 Declaration had an obligation to cease to grant any subsidies whether or not the subsidies were granted pursuant to legislation existing in 1947, unless a specific reservation was made.

Inter-company pricing rules

23. The United States representative argued that where the profits of a foreign subsidiary were not taxed the inter-company pricing rules of the country of manufacture would become more important. The United States maintained that tax administrators in Belgium might be willing, in some cases, to allow favourable pricing on export sales and that export companies were permitted simply to declare a 10 per cent mark-up on production costs by way of manufacturing profit. This would mean that the distortions created by the tax system became even greater.

24. The representative of Belgium stated that Belgian rules on inter-company pricing were analogous in substance to those laid down in Article 9 of the OECD Draft Double Taxation Convention and made it possible to ensure correct invoicing. The rules had recently been complemented and covered also operations or transactions between Belgian companies and persons or companies - whether or not linked to them - established in tax haven countries or even in countries with tax systems appreciably more advantageous for certain incomes than the Belgian tax system. The existing legal provisions allowed the administration considerable room for manoeuvre and was likely to induce companies to follow sound commercial practices and, when this was not the case, made it easy to correct the profit returns. The 10 per cent mark-up had been permitted in the past solely for the first two years of operation but at present the administration made a breakdown of total manufacturing and sales profits on the basis of appropriate criteria.

Effects of the territoriality principle as applied by Belgium for taxation of foreign dividends

25. The representative of the United States noted that Belgium in fact followed the territoriality principle since the profits of a foreign subsidiary were not consolidated with the profits of its Belgian parent and no Belgian tax was directly imposed on the subsidiary's profit. He went on to make the point that even if the subsidiary's profit was repatriated in the form of a dividend, 95 per cent of it was deducted from the taxable income of the company. In reality, the dividend was not expected to be taxed at all, as the remaining 5 per cent was considered to be deducted as ordinary expenses against the income of the recipient corporation. He argued that this amounted to both a permanent exemption from taxation of the subsidiary's income and a reduction of domestic profits of the parent. He noted that Belgian corporations were also entitled to a 95 per cent deduction for dividends from a domestic subsidiary and that this would appear to give domestic and foreign subsidiaries the same tax treatment but said that the difference was that the foreign subsidiary paid no Belgian tax.

26. The representative of Belgium replied that this rule was applicable for dividends derived from foreign subsidiaries which would normally have already been subject abroad first to corporate income tax and then to withholding tax on dividends. The granting of the deemed movable prepayment of 5 per cent of the amount of foreign dividends afforded only very inadequate remedy for the effects of a withholding tax collected abroad, as this withholding, which was often much higher than the 5 per cent deemed movable prepayment, could not be offset against Belgian tax and was therefore irrecoverable for the corporation. The hypothesis that no tax would be payable by the subsidiary either on its profits or on profits distributed by it was unacceptable. In such a case the transaction would undoubtedly come under the provisions designed to prevent tax fraud and evasion

(Article 46 and 250 of the Income Tax Code); those provisions were very effective and would result in the Belgian corporation being penalized in the determination of its taxable profits. The representative of Belgium concluded that in no case could the system be deemed an export subsidy since it was simply designed to remove obstacles to investment abroad resulting from double or multiple taxation and since it was furthermore of absolutely general scope.

27. In a counter argument the representative of the United States said that even if some tax was paid by a foreign subsidiary, there was still an exemption to the extent that Belgian tax exceeded the tax paid by the subsidiary.

Relation to the DISC legislation

28. The representative of the United States argued in general that, if the DISC legislation violated the General Agreement, then the tax practices of Belgium which operated to exempt a portion of sales income of exporting firms from direct taxes, must be found to constitute even clearer subsidies in violation of Article XVI:4. Whereas the DISC legislation provided only a deferral, the tax practices of Belgium amounted to a remission or exemption. The United States compared the effects of the principles behind its tax policy regarding foreign source income and the effects of the principles behind Belgium's legislation. It did not question the territoriality principle in so far as it represented a reasonable approach to the avoidance of double taxation, but argued that the intent of nations was irrelevant and that the effect of the Belgian practices was that foreign income which included the sales element on exports was not taxed by the home country and that there was therefore a remission or exemption of taxes with respect to exports. The focus should not, according to the United States, be on the tax rates of host countries, but on the home country and its potential for shifting export income abroad thus escaping virtually all tax. The representative of the United States stated that the current tax effects of the two systems were the same except that the DISC resulted in deferral while the Belgian system resulted in an exemption. The United States added that if it had utilized the territoriality principle it would have collected significantly less than the $3.8 billion which, it was estimated, would be collected on foreign source income in 1976.

29. In reply the representative of Belgium stated that the DISC legislation was designed specifically to favour export companies, while the Belgian measures were of a purely technical character and were designed to avoid international double taxation of taxpayers in general. Concerning branches, the Belgian régime did not differ substantially in its effects from the tax credit system applicable in the United States in a similar situation. Concerning dividends from subsidiaries, the representative of Belgium argued that the United States achieved the same result by allowing its domestic corporations to offset against United States tax

not only foreign tax on dividends as such, but also foreign tax charged to the subsidiary in respect of the corporate profits through which dividends had been distributed. Moreover, in Belgium all profits attained from "direct" exports were taxed on the entirety of the profits, whether the sale took place at home or abroad.

Bi-level pricing

30. Referring to the provision in Article XVI:4 relating to the sale of products for export "at a price lower than the comparable price charged for the like product to buyers in the domestic market", the representative of the United States argued that, if the Panel on DISC found that when the CONTRACTING PARTIES agreed that exemption of direct taxes in respect of exported goods was generally to be considered a subsidy within the meaning of Article XVI:4 they intended to create a presumption that such tax practices resulted in lower export prices in relation to domestic prices, and if the DISC Panel went on to find that the deferral of taxes on export sales income provided by DISC resulted in lower export prices, then the Panel on Belgian Tax Practices had likewise to find that the tax practices of Belgium providing for the total or partial exemption of export sales income of exporters located within Belgium were more likely to result in lower export prices and, therefore, were even more clearly prohibited by Article XVI:4.

31. The representative of Belgium maintained that unlike the DISC régime Belgium's tax régime did not allow sales by Belgian corporations or domestic subsidiaries in the foreign market at prices lower than in the domestic market and strictly conformed to Article XVI of the GATT. The tax rate was the same whether sales took place in the foreign or in the domestic market.

B. Article XXIII:2 nullification or impairment of benefits

32. The representative of the United States argued that a prima facie case of nullification or impairment was established where it was determined that the measure complained against violated the General Agreement and that, since the tax practices of Belgium constituted prohibited subsidies within the meaning of Article XVI:4, they had resulted in the prima facie nullification or impairment of benefits accruing to the United States under the General Agreement.

33. The Belgian position was that its practices were not in contravention of the GATT and that there was not, therefore, a prima facie case of nullification or impairment.

Conclusions

34. The Panel started by examining the effects of the income tax practices before it in economic terms. The Panel noted that the particular application of the territoriality principle by Belgium allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of Belgian taxes. In this way Belgium has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.

35. The Panel found that however much the practices may have been an incidental consequence of Belgian taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context.

36. The Panel also noted that the tax treatment of dividends from abroad ensured that the benefits referred to above were fully preserved.

37. In circumstances where different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, the Panel concluded that there was a partial exemption from direct taxes. The Panel further concluded that the practices were covered by one or both items (c) and (d) of the illustrative list of 1960 (BISD, 9 Suppl. p. 186).

38. The Panel noted that the contracting parties that had accepted the 1960 Declaration had agreed that the practices in the illustrative list were generally to be considered as subsidies in the sense of Article XVI:4. The Panel further noted that these contracting parties considered that, in general, the practices contained in the illustrative list could be presumed to result in bi-level pricing and that this presumption could therefore be applied to the Belgian practices. The Panel concluded, however, from the words "generally to be considered" that these contracting parties did not consider that the presumption was absolute.

39. The Panel considered that, from an economic point of view, there was a presumption that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort, and (c) increase of profits per unit. Because Belgium was an important supplier in certain export sectors it was to be expected that all of

these effects would occur and that, if one occurred, the other two would not necessarily be excluded. A concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel did not consider that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets. The Panel added that the extent to which tax havens existed was well known and that they considered this some evidence of the extent to which bi-level pricing had probably occurred.

40. The Panel therefore concluded that the Belgian tax practices in some cases had effects which were not in accordance with Belgian obligations under Article XVI:4.

41. The Panel considered that deviations from the principle of arm's-length pricing might arise from the recognized flexibility in the administration of the rules in this area and that the benefit would be increased to the extent that arm's-length pricing was not fully observed.

42. The Panel considered that the possibility of imputing profits to foreign operations outside the scope of domestic taxation might be affected by the fact that branches and subsidiaries were not subject to the test that a material installation and an autonomous management existed.

43. The Panel considered that the fact that these arrangements might have existed before the General Agreement was not a justification for them and noted that Belgium had made no reservation with respect to the standstill agreement or to the 1960 Declaration (BISD, 9 Suppl. p. 32).

44. The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in Belgian exports in some sectors and, although the possibility could not be ruled out that the tax arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI:1.

45. In the light of the above, and bearing in mind the precedent set by the Uruguayan case (BISD, 11 Suppl. p. 100), the Panel found that there was a prima facie case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.