The Belgian Allowance for Corporate Equity (ACE)

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The Belgian Allowance for Corporate Equity

- Why an ACE ?
- The ACE in Belgium: basic principles
- Empirical evidence: the ACE at work
- Conclusion

Why an ACE ?

- Ask an economist…
- Ask a Belgian policy maker…

Why an ACE ? *Ask an economist…*

- CIT generates distorsions, of which the two mains are
  - Taxation of marginal investment
  - Discrimination between debt and equity
- In addition to that
  - Adverse effect of CIT on growth
  - Evidence from the economic literature: in a small open economy, CIT increases the cost of capital and its final incidence could be passed on wages

Why an ACE ? *Ask an economist…*

- No tax on the marginal investment
- CIT only levied on economic rents
- Equal treatment of debt and equity

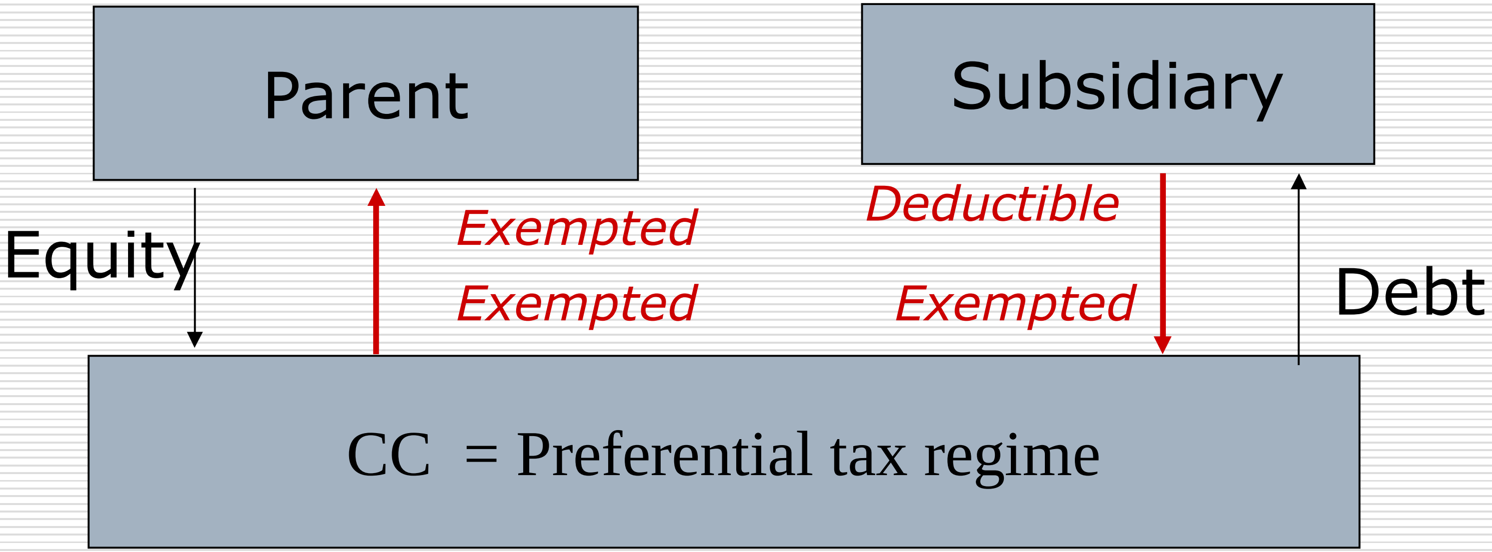
- The benefits of the ACE do not need to be extended to the existing stock of equity capital
- If extended, it creates a windfall gain for existing shareholders

Why an ACE ?
Ask a Belgian policy maker…

- Competitive pressure on CIT rates
- The EU code of conduct and the phasing-out of the coordination centre (CC) regime
  - The CC regime had to be dismantled (harmful)
  - The regime was designed to headquarters of multinational companies
  - Operates as a cost plus regime, with no taxation of financial intermediation
  - The major activity of the CC was to act as "internal bank" for multinational groups"

Why an ACE ?
Ask a Belgian policy maker…

- Typical use = triangle structure
  - CC financed by equity providing long-term debt to subsidiaries



Parent

Subsidiary

Equity

Exempted

Exempted

Deductible

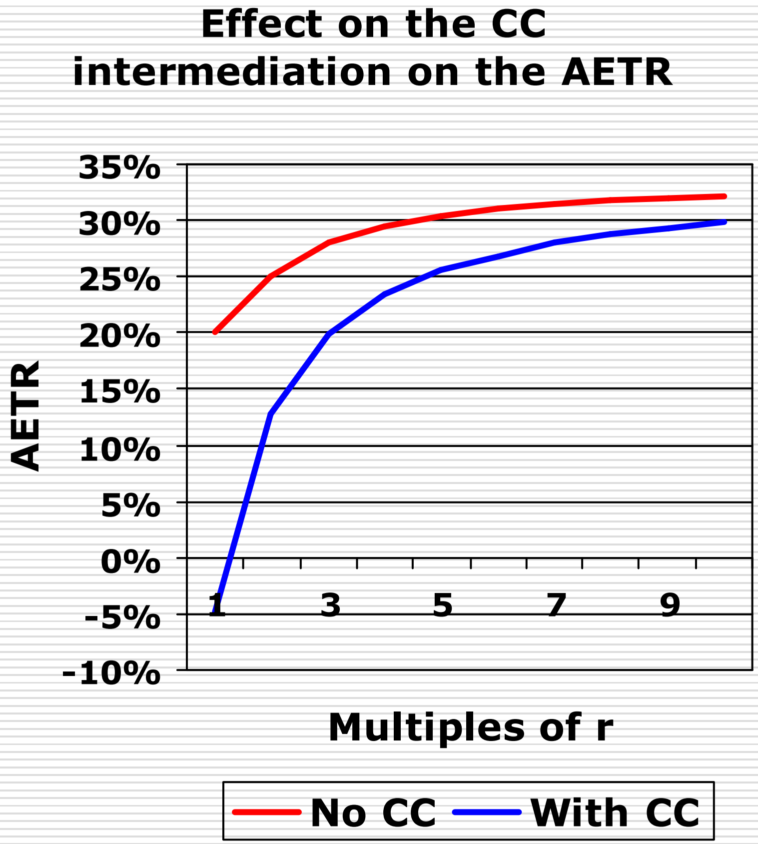
Exempted

Debt

CC = Preferential tax regime

Why an ACE ?
Ask a Belgian policy maker…

- ☐ Such triangle structures result in negative METR: the preferential tax regime is acting as a subsidy
- ☐ Lowers the ATR
- ☐ The preferential tax regime gave strong incentives for equity financing of the CC
- ☐ As a result, CC were overcapitalised



The ACE in Belgium
Basic principles

- Introduced in 2006
- Weak political consensus
- Base and rate of the ACE
- Part of a package
- Anti-abuse rules

Basic principles
Base and rate

- **Base**
  - Equity in the balance sheet
  - **This means including the existing stock of capital**
  - No condition on the use of equity
  - Participations in other companies deducted from the base
- **Rate**
  - Nominal interest rate on the “10 year government bonds” of the previous year
  - 3.95 for 2010
  - +0.5 point for small companies (“small” according to the corporation’s code)
- **Companies excluded**
  - Coordination centres that were still under the preferential tax regime
  - Other preferential or specific tax regimes (shipping regime)

Basic principles
Part of a package

- Tax cuts
  - ACE
  - General abolition of registration duties on capital increases
- Base broadening
  - Investment allowance repealed, apart for R&D and environmentally-friendly investments
  - Tax credits for new share issues repealed
  - Exemption of capital gains on shares: NET (of expenses incurred) instead of GROSS
  - Switch from the investment reserve to the ACE

Basic principles
Anti-abuse rules

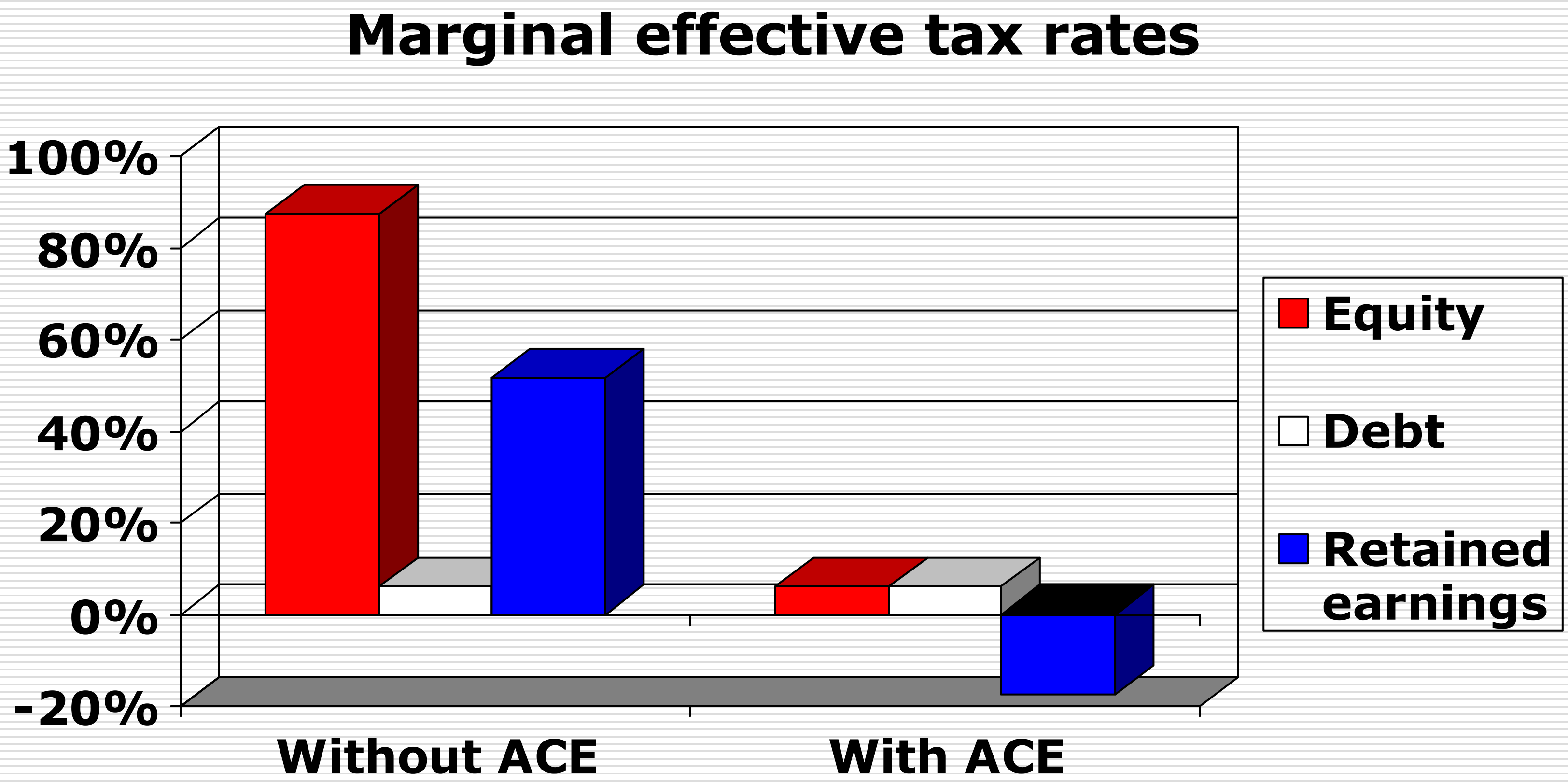
- General anti-abuse rule
- Specific rules: the value of some assets is subtracted from the ACE base
  - For example, immovable property at the disposal of managers and directors (=> “villa companies” de facto excluded)

Recent evidence: the ACE at work

- From a micro economic point of view
  - Marginal effective tax rates (K&F)
  - Average effective tax rates (Dev&Grif)
- From a macro economic point of view
  - Effective taxation of the corporate sector
  - Effects on economic activity and employment
- What about tax planning ?

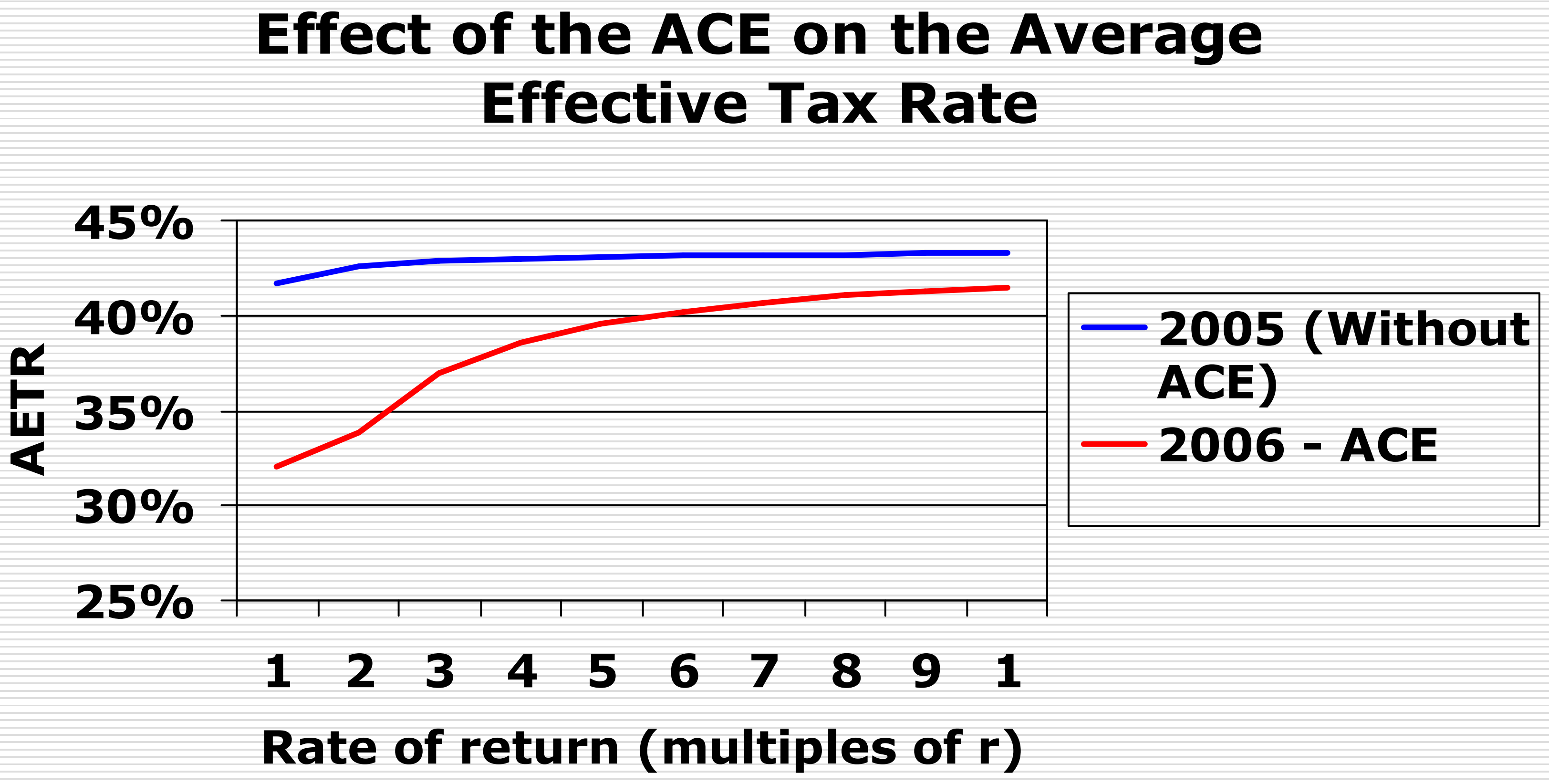
Recent evidence: the ACE at work

Micro economic approach



Recent evidence: the ACE at work

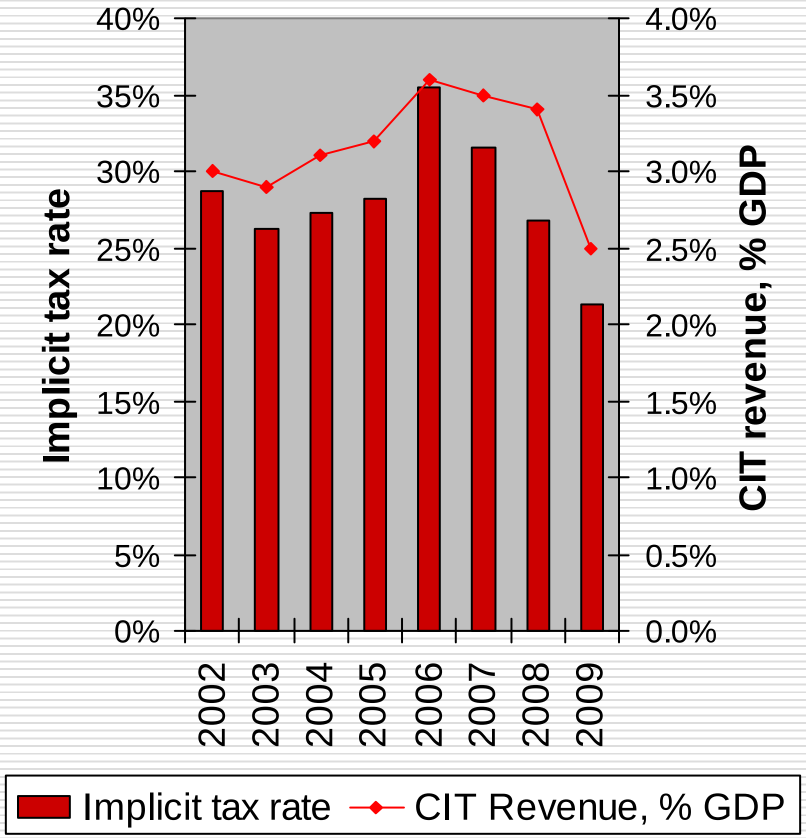
Micro economic approach



Recent evidence: the ACE at work

Macro economic approach

- ITR on corporations
  - = CITna/METB
    - *CITna =revenue (National accounts)*
    - *METB = macro economic tax base*
- Decrease in the ITR starting from the 2006 peak
- CIT revenue in % of GDP seems more stable
- Why ?



Recent evidence: the ACE at work

Macro economic approach

From the tax statistics

CITaccr = Tax due on taxable profits of a given year

TBbench : benchmark tax base (no tax expenditure, no ACE)

$$\frac{CITna}{GDP}=\frac{CITna}{CITaccr}\,x\,\frac{CITaccr}{TBbench}\,x\,\frac{TBbench}{METB}\,x\,\frac{METB}{GDP}$$

Timing effects

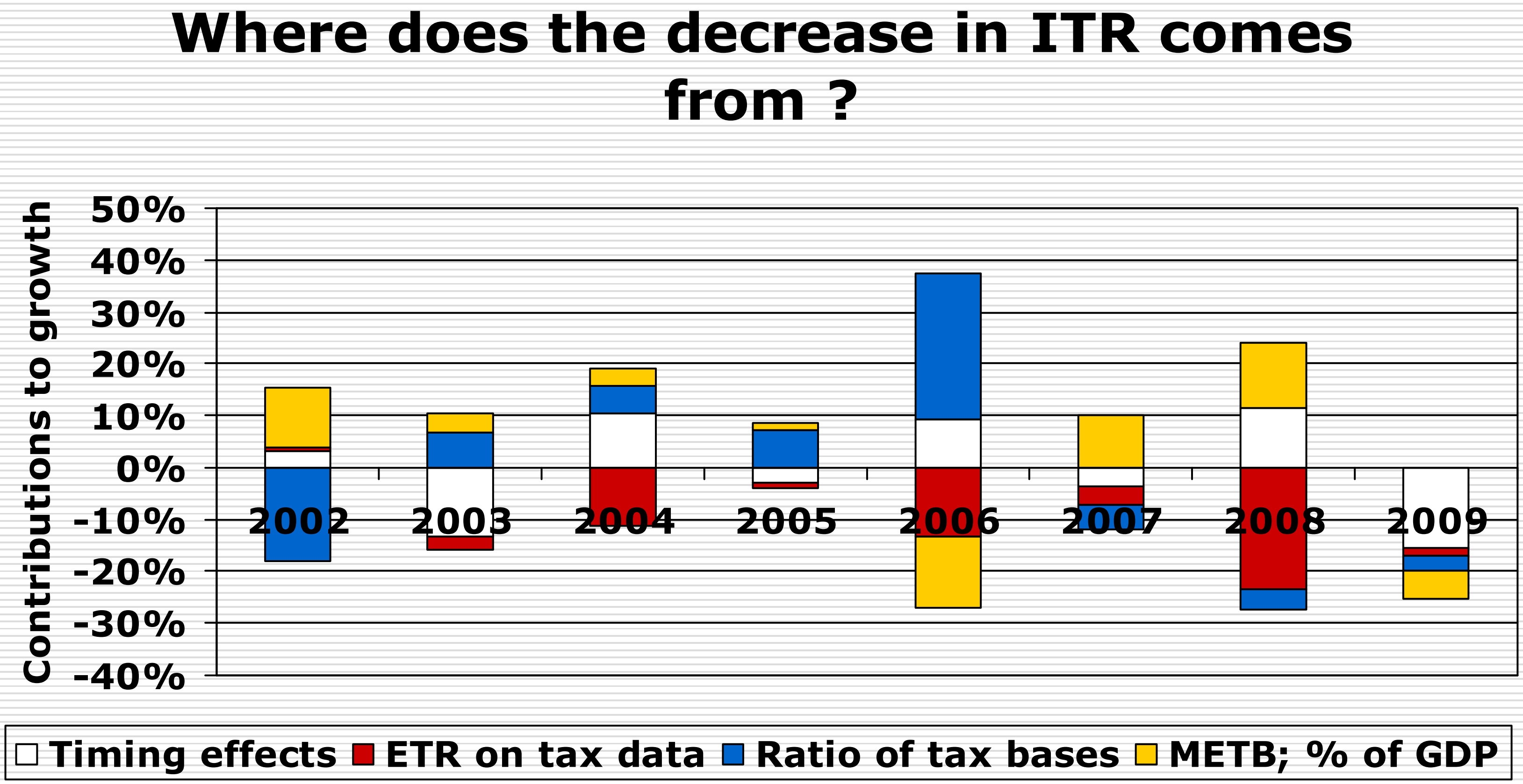
ETR (ex-post)

Ratio of the tax/macro base

ITR on corporations,
According to national accounts

Recent evidence: the ACE at work

Macro economic approach



Recent evidence: the ACE at work

Macro economic approach

- Decrease of the ex-post ETR (on tax data) in 2006-2008
- Partilally compensated in 2006 by
  - A timing effect in CIT perception
  - Base broadening (compensatory measures)
- Clear negative trend in 2007-08
- Increase in the ratio of the macro-economic tax base (METB) to GDP
  - Why…?

Recent evidence: the ACE at work

Macro economic approach

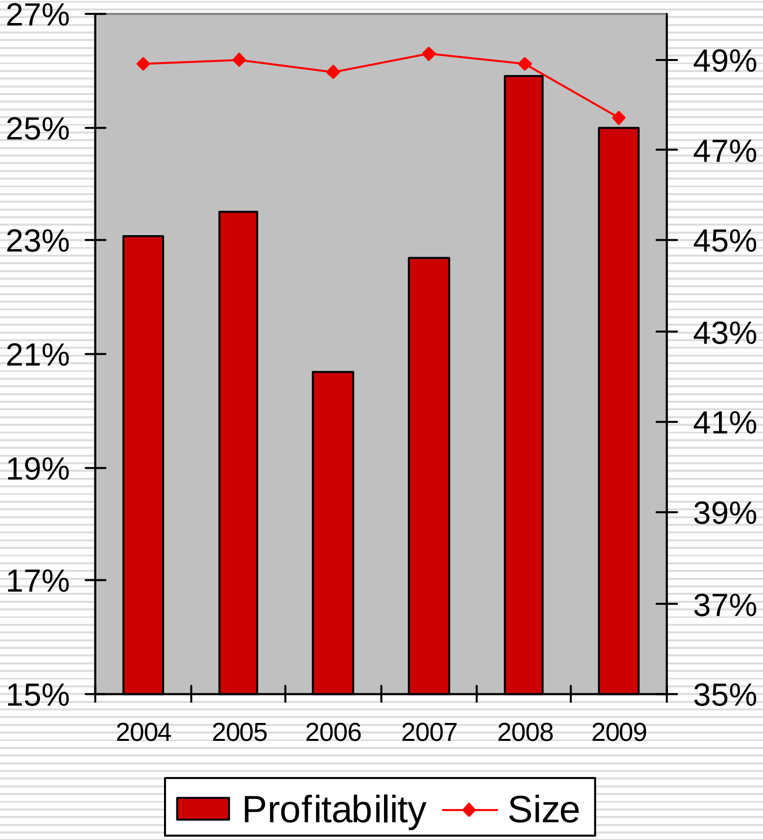
METB = macro economic tax base (NA)

NVAcs : net value added of the corporate sector (NA)

$$\frac{METB}{GDP} = \frac{METB}{NVAcs} x \frac{NVAcs}{GDOP}$$

Profitability

Size of the corporate sector



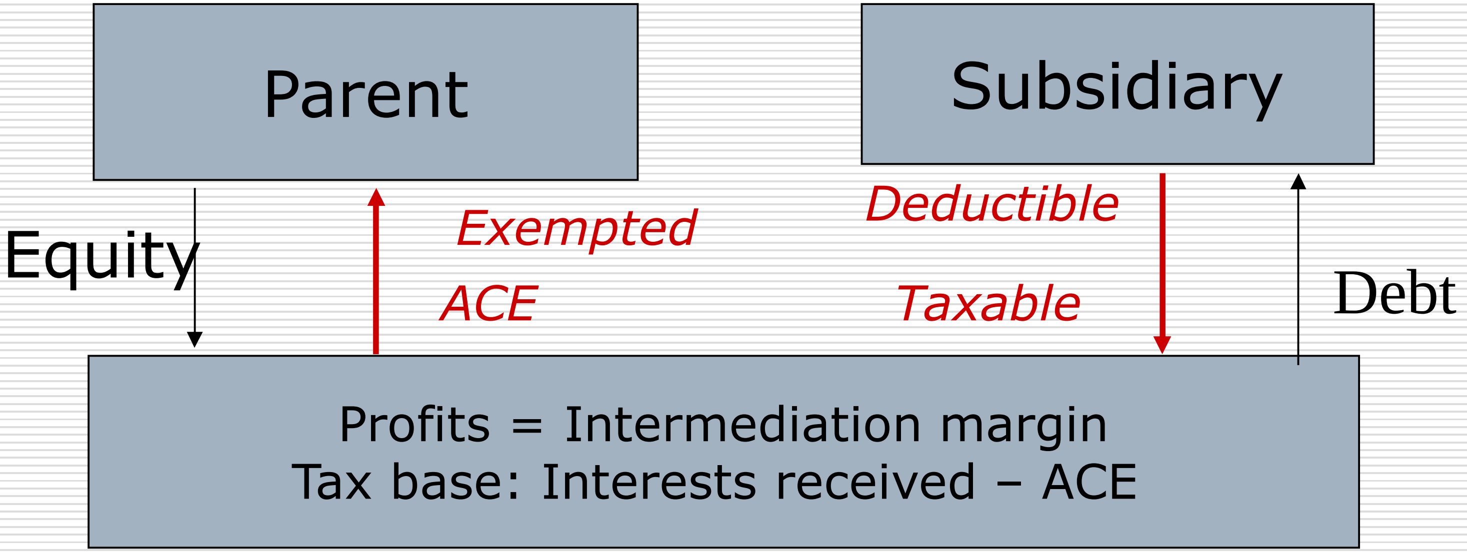
Recent evidence: the ACE at work

Macro-economic approach

- Summary
  - Peak in the ITR on corporations when the ACE was introduced
  - But ecrease of the ITR on corporations (according to national accounts) after the introduction of the ACE
  - Part of the compensation was one-off + timing effect
  - The macro economic CIT base enlarged
  - But this reflects an increase in gross profitability, not an increase in the size of the corporate sector
    - Consistent with the assumption of an increase in the localisation of equity with no increase in value added
    - If yes, no positive effects on economic activity and employment

Recent evidence: the ACE at work
What about tax planning ?

- Triangular structures under the ACE regime



Parent

Subsidiary

Equity

Exempted

ACE

Deductible

Taxable

Debt

Profits = Intermediation margin
Tax base: Interests received – ACE

Recent evidence: the ACE at work
What about tax planning ?

- Usual triangular structure:
  - The group sets up a financial company (FC), financed by equity (return = R_{ep}),
  - FC provides long-term debt to subsidiaries (return = R_{ds})
  - Profits = intermediation margin = R_{dS}-R_{ep}
  - Usual tax base of the FC= R_{ds}
  - Tax base under the ACE
    - Subsidiary: interest deduction
    - FC: Tax base = R_{ds} – ($Rate_{ACE}$*$Base_{ACE}$)
    - Parent company: dividends are tax exempt
  - Under the Coordination centre regime, tax base was = 0

Recent evidence: the ACE at work
What about tax planning ?

- Double Dip ?
- Presumptions…
  - The political decision resulted from the lobbying of the Coordination centres
  - Large groups and MNE’s asking for rulings on triangular structures
  - Confirmed by investigations on micro-data
  - Consistent with the macro economic evidence

Recent evidence: the ACE at work
What about tax planning ?

- Adverse consequences on CIT revenue
- Undermine the (fragile) political consensus
- Economic consequences
  - Tax planning acts against neutrality that the reform aimed to improve
  - Why should we subsidise « Internal banking » in large groups ?

Conclusions

- Fundamental CIT Reform
- Obvious merits
- The government opted for the « windfall gain » option, under pressure from lobbying
- For the same reason, no anti-abuse rule against the use of triangle structures
- Consequences: higher cost for the budget, reduced economic gains
- The political consensus remains weak
  - A deduction for risk capital or a risky deduction for capital…?