

## WILL THE PROPOSED "TAXATION OF SAVINGS INCOME DIRECTIVE" BE THE VICTIM OF ITS CONTRADICTIONS?<sup>1</sup>

Marc Dassesse<sup>2</sup>

The European Commission presented to the Council on June 4, 1998, a (new) "Proposal for a Council Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community".<sup>3</sup> In order to be adopted, this proposition requires the unanimous agreement of all the Member States within the Council, but only the opinion of the European Parliament.

It will be recalled that a similar initiative had already been proposed at the end of the Eighties, but did not succeed for several reasons, which are not analysed here.

Will this proposal have more chances of success than the previous one, taking into consideration the switch to Monetary Union by January 1999?

### Behind One Paying Agent There Hides Another

The former proposal was aimed at establishing a *minimum* deduction within the Community for all interest payments made by a borrower established in one Member State to a resident of another Member State.

Amongst other difficulties, this system ran the risk of penalizing borrowers residing

---

<sup>1</sup> Previously published in the *Journal of International Financial Markets "Law and Regulation"*, Sweet & Maxwell, Vol. I, Issue 2, February 1999, p. 78-81.

<sup>2</sup> Marc Dassesse, Member of the Brussels Bar (McKenna & Cuneo, LLP) Professor at the Free University of Brussels (ULB) 56, Rue des Colonies, Box 14, B-1000 Brussels, Belgium.

Tel: +(32 2) 278 1211 Fax: +(32 2) 278 1200. E-mail (mdassess@ulb.ac.be).

<sup>3</sup> OJ 212/13 of July 8th, 1998.

in the Community in relation to borrowers residing outside the Community who, of course, were not subject to the proposed withholding tax. True, the proposed deduction was not to be applied in the case of interest payments made by a debtor residing in the Community to a non-Community resident. However, it is quite difficult for a debtor (for example, the issuer of bearer bonds) to determine whether the beneficiary of the interest resides within the Community or not.

In order to meet this (first) difficulty, the new proposal provides that the obligation to withhold does not lie with the debtor but with the so-called "paying agent" (who may however coincide with the debtor).

However, the proposal defines the: "paying agent" as meaning "any economic operator who is responsible for the payment of interest for the *immediate* benefit of the beneficial owner, whether he be the debtor of the capital which produces the interest itself or the operator charged with the payment of interest by the debtor *or [by] the beneficial owner...*".

In practice, the paying agent, within the meaning of the proposal, will (generally) be the banker or the financial intermediary with which the beneficiary of the interest has his account.

It is regrettable that the proposal gives to the term "paying agent" a meaning which is totally different from its ordinary meaning in financial transactions. Indeed, this gives rise to significant misunderstandings.

It is in order to avoid such misunderstandings that we will use hereafter the term "the bank of the beneficiary" instead of "the paying agent of the beneficiary".

### **The Exchange of Information As An Alternative to the Withholding of Tax**

Another substantial change from the previous proposal is as follows: the Member State of the bank of the beneficiary has the choice between imposing the withholding of a (compulsory) minimum tax on interest payments to residents of other Member States, *or* not to withhold tax but instead to communicate the following information to the competent tax authorities of the Member State where the client resides: "at least the amount of interest paid, the date of payment, and the identity of, and residence declared by, the beneficial owner of the payment". "The provision of information shall be automatic and shall take place at least once a year, within six months of the end of the preceding calendar year [during which the interest payments were made]".

### **Withholding Tax Option: Exemption Certificate Available**

If the Member State of the bank has opted for the withholding option, the deduction must be at a minimum rate of 20%. In such a case, under the new proposal, "no other withholding tax shall be levied within the Community on interest paid to beneficial owners [where they are established in another Member State]". However, this does not mean that the net interest received by, say, a Belgian resident from a Luxembourg bank no longer needs to be reported to the Belgian tax authorities! In other words, if the Member State where the bank is located has opted for the withholding tax system, this deduction does not absolve the beneficiary from his reporting "and tax paying" obligations in his Member State of residence.

The proposed Directive makes provision for two adjustments to this principle. However, they both assume (in our example) that the Belgian beneficiary of the interest received from a Luxembourg bank decides of his own initiative to make himself known to the Belgian tax authorities.

The first adjustment is that the Belgian beneficiary may avoid the withholding of tax in Luxembourg by obtaining beforehand a certificate from the Belgian tax authorities. In addition to the identity of the Belgian beneficiary this certificate must indicate the "paying agent", i.e. the Luxembourg bank with which he is dealing. Moreover, the certificate that has to be obtained from the Belgian tax authorities must specify the (gross) amount of interest received from the Luxembourg bank and the date when it will be paid. It can reasonably be assumed that there will not be a long queue before the offices of the Belgian tax authorities in order to obtain such "exemption" certificates.

The second adjustment is as follows: the Belgian tax authorities (in the example above) must give to the Belgian taxpayer who has been subjected in Luxembourg to a (minimum) 20% withholding tax on the interest received from his Luxembourg bank an equivalent tax credit against his Belgian tax liability on the same interest.

Thus, if the Luxembourg withholding tax is 20% and the Belgian tax on (gross) interest income is also 20%, the Luxembourg deduction of 20% will totally offset the Belgian tax which is payable on the same interest income.<sup>4</sup>

Here too, it is a safe bet to expect that few Belgian taxpayers will claim the benefit of this Belgian tax credit. Indeed, in order to obtain the tax credit, the Belgian

---

<sup>4</sup> It is worth noting that if the Belgian tax on interest income is, say, 15%, the taxpayer may obtain a repayment of the excess Luxembourg withholding tax (i.e. 5%) upon production to the Luxembourg tax authorities of a certificate issued by the Belgian tax authorities.

taxpayer must of course report to the Belgian tax authorities the interest received in Luxembourg.

### A Proposal Based on A Wrong Assumption

According to the recitals of the proposal, "savings income in the form of interest payments from direct investment *is taxable income for residents of all Member States*".

However, this is not the case. In most, if not in all, Member States, certain specific types of interest income are exempted from tax. Additionally, there is also usually a minimum level of income which is not taxable, irrespective of whether it is derived from professional activities or from savings.

The proposal itself explicitly recognizes this situation: indeed, it only imposes obligations on the Member States with respect to the interest paid by a local bank to a client residing in *another* Member State.

In other words, the proposal does not impose any obligations on a Member State with regard to interest paid by a local bank to local residents.<sup>5</sup> If it were to do otherwise, the proposal would be interfering with the fiscal prerogatives of the Member States regarding their own residents, and would thus breach the principle of subsidiarity<sup>6</sup> to which the proposal itself makes express reference. Accordingly, nothing prevents a Member State from applying the withholding tax option for interest paid by its banks to residents of other Member States while providing for complete tax exemption for interest paid to local residents. In so doing, such a Member State will turn itself into a tax haven for its own residents. Indeed, it is then in the interest of such residents to seek payment of interest from local banks with, possibly, the added benefit of domestic banking secrecy laws. If, instead, they seek to receive interest payments in another Member State, they will lay themselves open to being subject to either a minimum deduction of 20%, or to the information exchange system which they may be eager to avoid.

As far as Belgium is concerned, this would be a particularly efficient way of repatriating national savings which have emigrated abroad as well as addressing the difficult problem of financing the Belgium public debt after the switch to the Euro.

---

<sup>5</sup> The same applies for non-Community residents.

<sup>6</sup> Subsidiarity is the principle under which Community action must be strictly limited to those areas where the action in question cannot be achieved by the Member States alone but solely through Community action.

Other Member States may well be eager to do the same.

### **The Euro-bonds Problem: No Exemption**

The previous proposal contained a far-reaching exception. It provided namely that the compulsory minimum tax would not apply to interest relating to Euro-bonds (usually issued in the form of bearer bonds).

In spite of the understandable worries expressed in professional circles - especially in London - no such exception in favour of Euro-bonds exists in the new proposal.

Presumably, the "in" Member States are concerned that the inclusion of such an exception could result in the creation of a new tax haven situated within the Community, but located outside the Euro-zone.

### **Despite Fervent Denials Banking Secrecy Will Be Weakened**

During the preparatory work for the new proposal, it was stated on several occasions that the choice given to Member States between the withholding tax option and the information exchange option allows Member States who so wish to maintain their banking secrecy rules unchanged.

As the recent developments in Russia have demonstrated once again, it is when a Minister of Finance declares that his national currency will be defended at all costs that the risk of devaluation is at its highest.

The same applies as far as the preservation of banking secrecy in the context of the new proposal is concerned.

In our opinion, a Member State which chooses to adopt the withholding tax option in order to preserve its banking secrecy laws will nonetheless be required to significantly weaken such laws in order to comply with the obligations imposed by the proposed directive.

### **Two Examples May Illustrate this Point:**

- The Member State of the client's bank must "within its territory, adopt and ensure the application of the procedures which allow [the bank] to identify the beneficial owners and their place of establishment [and] to ensure that

the tasks necessary for the implementation of this Directive by [the bank] paying the interest ... [to a resident of another Member State]" are properly carried out. How will Member States be able to do this without having access to the identity of the bank's clients?

- In cases where the place of residence of a client is in doubt for tax purposes, the tax authorities of the various Member States concerned "shall agree, within a reasonable period of time, on a single place of residence". How will it be possible to do this without knowing the identity of the bank's client?

#### **A Boon for Banks Outside the Community?**

The withholding tax option (or the information exchange option) will only apply if the bank with which the client is dealing, is established in another Member State. In other words, if the client deals with a bank established outside the Community, the Directive will not apply, even if the interest relates to bonds issued within the Community.

In order to tackle the risk that the client moves his account to a bank outside the Community, the proposal provides two counter-measures:

- firstly, negotiations are to be conducted with financially significant third countries in order to ensure the effective taxation of income from savings by introducing a similar system for Community residents;
- secondly, Member States "which have dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories are committed to taking appropriate measures ... [to] ensure that provisions ... equivalent to those contained [in the Directive, once it has been adopted] may be applied in those territories."

However, the practical impact of those commitments is far from obvious.

#### **An Extensive Definition of Interest**

The proposal includes in the definition of interest falling within its scope zero-bonds,

capitalization bonds, as well as UCITS<sup>7</sup> "which invest directly or indirectly more than 50% of their assets in debt-claims or corresponding securities". Under the proposal, "the interest to be taken into consideration ... [in the two first cases] is the difference paid by the paying agent on redemption, between the capital reimbursed and the issue price of the corresponding securities".

The proposal ignores, however, all the problems that this assimilation raises. For example, a person who on November 1st, 2000, buys for 122 a capitalization bond issued outside the Community on January 1st, 1999 at 100, which is repayable on December 31st, 2000, at 124, would incur a (minimum) withholding tax of 4.8, that is to say 240% of the interest actually received.

This is not all: the proposal states in its recitals that, if necessary, similar measures will have to be envisaged with respect to pensions and insurance benefits.

### **Conclusion**

The impression given by the proposal is, with due respect, that of a makeshift job, for which however the Commission is not to blame. The Commission cannot be expected to fit square pegs into round holes.

Member States should recognize, instead, that a coherent approach to European tax issues is only possible if they no longer attempt to superimpose a thin layer of Community tax law on widely diverging national tax systems. The only way forward is to face up to the inevitable loss of national sovereignty in tax matters, and to expand the role of the European Parliament so as to fill the vacuum arising as a result of the sharply reduced prerogatives of the national parliaments. This is especially the case for Member States which have joined the Euro-zone and which are bound by the "stability pact" that goes with it.

The democratic principle of "no taxation without representation" must also be observed at the European Community level. If not, the European Community may see a further decline in popular support at the grass-roots level, with all ensuing risks for its future.