THE EUROPEAN COMMISSION'S PROPOSAL FOR A DIRECTIVE ON TAXATION OF SAVINGS INCOME

Mark Robson[1]

New lamps for old?

On 20th May 1998 the Commission of the European Communities published a "Proposal for a Council Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community". This has significant implications for amongst others, UK resident financial institutions. The definitive text in English[2] was transmitted to the Council on 5th June, when the Commission's previous proposal of 10th February 1989 for a common system of withholding tax on interest income[3] was simultaneously withdrawn.

Given that the 1989 proposal failed to find the necessary unanimous agreement of Member States in almost a decade, one might reasonably question why its replacement, considerably more extensive in scope, should not *a fortiori* meet with the same fate. However, the Commission was acting in response to consideration at the meeting on 1st December 1997 of the Council of Finance Ministers (ECOFIN) of a tripartite tax package[4], the other components being a proposal for a directive on intra-group interest and royalty payments[5] and the establishment of a "Code of conduct for

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1 Mark H Robson, Senior Manager and Tax Adviser, Financial Intermediaries Division, Bank of England, Threadneedle Street, London EC2R 8AH. Tel: (0171) 601 3811 Fax: (0171) 601 3804 Email: institutions.fid@bankofengland.co.uk.

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2 COM(98)295 final.

3 COM(89)60 final and OJC 141 of 7th June 1989, p 5.

4 Conclusions and resolution reported in OJC 2/1 of 6th January 1998.

5 COM(98)67 final.

business taxation", to be developed by a group chaired by the UK Financial Secretary. The political climate has therefore changed somewhat.

This article reviews briefly the scope of the draft directive, which on the face of the matter is rather strange, some of the consequences were it to be implemented, and likely next steps.

Background

Some Member States have long experienced difficulty in taxing interest income of their residents earned in a different Member State. Germany and Belgium are the clearest examples, both suffering from the ease with which deposits can be made in Luxembourg banks, effectively with absolute secrecy and free of tax. The German government is faced with the further problem that the Federal Constitutional Court ruled on 27th June 1991 that the tax treatment of interest income, in enforcement as well as policy, had to be more consistent with that of other income because of the constitutional principle of equality.[6] Germany has concluded that this cannot be achieved by action at national level alone.

Although Article 11 of the OECD Model Tax Convention provides for 10% maximum withholding tax on interest in the source country, in practice most OECD countries have given up taxing interest income of non-residents at source, either unilaterally or in their bilateral conventions. On one interpretation, this is a natural consequence of competition between sovereign states, driven by the existence of classic tax havens with no taxes on non-residents and banking secrecy, which can effectively compete for international deposits now that foreign exchange controls have been dismantled in most countries.

The legal basis for a directive is Article 100 of the Treaty of Rome, so that it would require unanimous agreement of the Member States in Council, as well as taking account of the opinions of the European Parliament - which has the opportunity to propose amendments at this stage, but not later - and the Economic and Social Committee.

The object of the draft directive

The recitals place the directive in the context of liberalisation of capital movements since 1990, and which since 1994 has been incorporated in the Treaty itself. The

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6 An excellent account of the attempts to find a domestic solution in response to this decision can be found in the Deutsche Bundesbank Monthly Report of January 1994.

reason given for restricting the proposal to interest is that it is taxable in all Member States. This might seem obvious, but Iceland, for example, does not tax interest; various EU countries do not tax proceeds of life insurance policies or other returns to savings in the hands of individuals; and dividends, unlike interest, are not generally deductible from the corporate tax base.

Although it is noted that "residents of Member States are currently able to avoid any form of taxation on interest they receive in a Member State other than the one in which they are resident", it is evasion that is meant.[7] The phenomenon that is objected to is a resident of country A depositing in a bank in country B which does not collect any tax nor provide information to tax authorities of country A, to whom the interest is deliberately not reported by the resident. Of course the same may apply to residents of country B depositing in banks of country A; both countries intend to tax their own residents' global interest income, but both their tax bases are being eroded.

The argument presented for action at the European level is, in fact, not that erosion of the direct tax base through evasion is bad of itself, but that this effect causes economic of effective taxation of savings income within the Community."[8] The reason for slight sensitivity on this point is perhaps the traditional reluctance of the Commission to become involved with matters of direct taxation which, in accordance with the principles of subsidiarity and proportionality set out in Article 3b of the Treaty, have distortions to the internal market, which would be mitigated by "ensuring a minimum" to date been left almost entirely to Member States.[9]

Summary of the directive

The scope of the directive is restricted in several dimensions. First, it applies only to payments of interest to individuals for their own benefit (i.e. not as agents or nominees), when they are resident for tax purposes in a different Member State to that

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7 Recital (5): a common error in translation from French, in which the proposal was originally drafted.

8 Recital (7).

9 The exceptions being directives 77/799 (mutual assistance), 90/434 (corporate mergers, divisions, etc), 90/435 (parent/subsidiary dividends) and convention 90/436 (arbitration to eliminate double taxation).

in which a "paying agent" is established. Tie breaker rules are proposed for the case of multiple residence.[10]

The definition of interest starts from the OECD Model, i.e. "income from debt-claims of any kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular income from public debt securities or bonds, including premiums and prizes attaching to the latter."[11] Penalty charges for late payment are excluded, but the increase in value of debt-claims issued below par is included on redemption, as is income distributed by UCITS[12] with more than half their assets in debt-claims and securities (and the corresponding increase in value in any case where units are issued below redemption price). Unlike the 1989 proposal, Eurobonds are included, as are government securities and indeed all bearer and registered debt and convertible instruments.

Territorial scope is limited to the case of a "paying agent" established within a territory to which the Treaty of Rome applies.[13] This therefore excludes, for example, the Isle of Man and Channel Islands but includes Gibraltar.

The concept of "paying agent"for the purpose of the directive is, however, rather closer to what we understand in UK law by "collecting agent", since it is defined as "any economic operator who is responsible for the payment of interest for the immediate benefit of the beneficial owner, whether he is 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".[14]

The most unusual feature of the directive is that it allows Member States to choose between two approaches to applying it, although whichever is chosen must be applied universally, regardless of the type of asset on which the interest arises and regardless of the Member State of residence. This is christened the "co-existence model"[15]: "Member States shall opt either for the transmission of appropriate information to the Member State of residence or for the levy of a withholding tax."

10 Article 3(c).

11 Article 5.

12 Undertakings for collective investment in transferable securities, within Council Directive 85/611/EEC.

13 Article 6.

14 Article 3(b).

16 Article 8 of Council Directive 77/799/EEC.

Under the information system, the tax authorities of the Member State in which a paying agent is located would need to collect information on the amount of interest paid, date of payment, and identity and residence of individual beneficial owners, and transmit that information to the Member State of residence. But the reciprocity provision of the Mutual Assistance Directive[16] would be disapplied, so that the obligation placed on tax authorities under this directive is unilateral in the case that the other Member State has adopted the alternative, withholding tax system.

The reason is that Member States which particularly value banking secrecy will choose the withholding tax system. In this case, instead of providing information, a minimum 20% withholding tax will be applied by the paying agent; but, in a further complication, the tax must be waived if the beneficial owner has provided a certificate from the tax authorities of his Member State of residence. If the withholding system is chosen, a Member State can, of course, also provide information under domestic or bilateral provisions if it wishes.[17]

This option looks rather like the corresponding United States, Swiss, Japanese and French models to encourage voluntary disclosure of identity while preserving banking confidentiality - but with the critical difference that in those cases, the withholding tax rate is set markedly higher, at rates between 30 and 50%.

Where the withholding tax is levied, it is to be creditable against tax in the residence country (assuming, of course, that the interest income is declared there - but since, in that case, the certification procedure is supposed to prevent tax being withheld, it is unclear when this could happen) and, conversely, where irrecoverable withholding tax has previously been suffered in a third country, then withholding tax levied under this directive is to be correspondingly reduced. [18]

Evaluation: some obvious difficulties

The so-called co-existence model has been introduced to try to satisfy two contradictory policy positions. Some countries (Denmark, Luxembourg, the Netherlands, Sweden) have no withholding tax on interest at all. They hold that it is appropriate for interest to be included in total income of their residents, taxed at such

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17 Confirmed in Article 8 paragraph 3.

18 Article 10

progressive rates as national governments determine from time to time. Other countries either hold that a final, universal flat rate of tax should be applied at source (for which there are very respectable economic arguments); or that, because of banking secrecy, while in principle interest should be taxed along with other income at progressive rates, in practice withholding tax at source provides an important mechanism to ensure at least a minimum level of taxation in the event of evasion. Austria, Belgium, Finland, Greece, Ireland, Italy and Portugal are generally in the first category; France, Germany, Spain and the United Kingdom in the latter, although in many countries the position varies, pragmatically, according to the type of instrument on which interest is paid.

There is no incentive for a country to choose the information system, given that some other countries will choose to withhold. Assuming the Netherlands and Germany were to adopt opposite positions, Germany would collect 20% minimum tax on interest paid from German banks to Netherlands residents and not provide information to enable the Netherlands authorities to collect further tax due. If the interest is, nevertheless, declared (but for some reason, the certification procedure not invoked) then credit must be given for the tax withheld in Germany. Yet the Netherlands has nothing to gain from providing information to Germany unilaterally on German residents' bank deposits in the Netherlands, and hence is in an unequivocally worse position.

The co-existence model therefore appears incoherent, unless there was some arrangement for redistributing any additional tax revenue from withholding to information system countries. The directive is silent on this question. Of course, there may be scope for a trade-off between this directive and other measures; Italy and others have indicated that they see the fate of the interest and royalties draft directive as linked to this one. [19]

Although the prospect seems highly implausible given the Chancellor's stated opposition, one can try to imagine the likely consequences for the UK if the directive were to be implemented in precisely its current form. Member States have considerable discretion as to how to implement the directive. If the UK adopted the withholding tax system, one could envisage the current self-certification NOR regime for bank deposits[20] being amended to cover individuals ordinarily resident outside the EU, rather than the UK. But unlike the present regime, procedures would need to be in place both for banks and building societies to forward the information at least annually to the Inland Revenue on all EU non-UK depositors, and to waive the withholding tax under the new certification procedure.

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19 Or, in the broader European scheme, a country might choose to put itself at a disadvantage under this directive in exchange for a gain on some other measure(s) completely unrelated to taxation.

20 Section 481(5)(k) ICTA 1988

Because the same system must be applied to all sources of interest, under the withholding tax system gilt interest would not be able to be paid gross to EU non-UK individual holders, abruptly reversing the recent trend[21] (although gross payment would still be acceptable within the UK), but the directive refers to beneficial, not legal, ownership. Since no details of beneficial ownership are held on the gilts register, new information procedures would be required here too.

The interest articles of all bilateral treaties with other Member States would presumably have to be amended to provide for maximum 20% withholding tax to be levied at source, and it is difficult to see how the extension of personal allowances to EEA nationals could be maintained to be set against interest income,[22] as well as the exemption from withholding tax for qualifying certificates of deposit and qualifying time deposits,[23] in so far as these were held by residents of other Member States.

Some non-resident deposits, not necessarily restricted to residents of other Member States, would certainly leave the UK. The amount is difficult to judge. But a more significant effect could arise in respect of individuals investing directly in the Eurobond market, which established itself in London precisely in response to the original US attempt to impose a similar regime. The Taxes Act definition of "Eurobond" makes no reference to the characteristic, international nature of the market but instead hinges on the fact that "the interest ... is payable without any deduction in respect of income tax or of any tax of a similar character imposed by the laws of a territory outside the United Kingdom".[24] The most important exclusion in the directive for this purpose is in the last aspect of the definition of "paying agent": "only the last party established within the territory of the European Community which carries out that transaction".[25] Such agents located outside the EU and last in the chain of payment to EU resident individuals are apparently not affected.

The retail market would be potentially more affected by the extension of the definition of interest to UCITS investing more than 50% of assets in debt-claims or securities (apparently excluding SICAV vehicles, whenever these are not within the UCITS directive). The other extension of the definition, to discount on redemption, would

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21 The latest change being the extension of FOTRA conditions in Clause 156, Finance (No. 2) Bill.

22 Section 278(9) ICTA 1988, introduced by section 145 FA 1996.

23 Section 481(5)(a) ICTA 1988.

24 Section 732(5)(e) ICTA 1988.

25 Commentary to Article 3.

appear to be trivially avoidable by transfer of discounted securities to a non-individual immediately before the redemption date.

Apart from the fact that, as noted above, choice of the information system seems unattractive to Member States, it is hardly very obvious how it could be made to work in the case of bearer instruments. Yet it is fairly clear that all problems could be avoided if the relevant operations could be moved outside the EU: to Switzerland, for example. The Commission's directive is accompanied by a draft decision for Council, for Member States to agree to promote the adoption of measures equivalent to those of the directive in third countries[26] as well as in dependent or associated territories, or territories in which Member States have particular responsibilities or fiscal prerogatives. It is unclear whether, if the UK subscribed to such a decision, it would necessarily include the Isle of Man and Channel Islands within the scope of "dependent or associated territories"; more generally, it is unclear what incentive third countries would have to adopt such measures, given the fundamental incoherence of the co-existence model.

Alternative approaches to the basic problem can be envisaged. The most obvious is an international attack on banking secrecy. It is significant that measures against money-laundering have won very broad acceptance, including traditional tax havens. In a communiqué issued on 9 May 1998, G7[27] Finance Ministers warmly welcomed the OECD[28] agreement on action to tackle harmful tax competition[29] and strongly endorsed the OECD recommendations. But the focus of the communiqué was on improved availability of information to tax authorities, and in particular, addressing the problems caused by restricted access to banking information and enhancing the capacity of anti-money laundering systems to deal effectively with tax related crimes.[30]

Next steps

26 Also included, with apparent duplication, in the directive itself as Article 11.

27 Canada, France, Germany, Italy, Japan, United Kingdom and United States.

28 The OECD comprises the 15 EU countries; the United States, Canada and Mexico; Australia, New Zealand, Japan and Korea; Iceland, Norway, Switzerland and Turkey; the Czech Republic, Hungary and Poland.

29 The report "Harmful Tax Competition: An Emerging Global Issue" was approved and its recommendations adopted by the Council of the OECD on 9th April 1998, although Luxembourg and Switzerland abstained.

30 See HM Treasury press release 71/98 of 9th May 1998, "G7 Initiative on Harmful Tax Competition".

The proposals have been transmitted from the Commission to the Council, it will now be considered by national officials in a working group of the Council, reporting back to successive ECOFIN meetings on progress. The pace of negotiation and amendment will depend very much on the enthusiasm of successive national presidencies, but the Austrians taking over the reins from the UK on 1st July are keen to press ahead. Early agreement, however, seems most unlikely given the fate of the 1989 draft directive, and must depend on developments on the associate measures within the OECD and G7. Even the application date proposed in the draft, 1st January 2001, seems hopelessly optimistic, not least because software engineers are currently preoccupied with Euro and Year 2000 issues.