

A Proposal for a Simpler, Fairer EU Withholding Tax

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In this article, Jarass proposes a simple withholding tax system that would comply with the EU interest and royalty directive to prevent double taxation as well as nontaxation.

The European Commission's political guidelines call for the commission to address fair taxation and fight against tax fraud as key foundations of an economy that works for citizens of the EU.¹

A recent EU initiative calls for a new system of withholding taxes to avoid double taxation.² It aims to introduce a common, EU-wide system for withholding tax on dividend or interest payments. It will include a system for tax authorities to exchange information and cooperate with each other. In addition, a recent draft report of the European Parliament calls for a new European withholding tax framework.³

I. Tax All Interest and License Fees

The following proposal for a simple withholding tax system⁴ prevents double taxation as well as nontaxation. The proposal was presented to the European Parliament on October 27 and includes the following key proposals:

- To impede tax evasion via low-tax regimes, the proposal advocates for a withholding tax on all interest and license fee payments, not only — as today — on some payments.
- The proposed withholding tax should be levied irrespective of the tax residence of the final beneficiary, including domestic payees.
- The withholding tax should be applied without any relief at source (see Section II). This means that for every payment withholding tax must be paid to the domestic tax administrations.
- In return, all withholding taxes paid to foreign tax administrations⁵ should receive a tax credit by the tax administration where the income is declared and taxed. This avoids today's lengthy, resource-intensive, and costly reimbursement procedures.

This proposal guarantees that all income is indeed taxed once within the European Union as postulated by the EU interest and royalty directive.⁶

¹European Parliament, "Report on Financial Crimes, Tax Evasion and Tax Avoidance," 2018/2121(INI) (Mar. 26, 2019).

²European Commission, "Withholding Taxes — New EU System to Avoid Double Taxation" (Sept. 28, 2021).

³*Id.*

⁴For detailed explanations, see, e.g., Gustav M. Obermair and Lorenz Jarass, "What an Individual EU Country Can Do Unilaterally to Counteract BEPS," *Tax Notes Int'l*, Aug. 24, 2015, p. 697; Obermair and Jarass, "European Union/Germany — Unilateral Withholding Tax to Counteract Base Erosion and Profit Shifting," 55(11) *European Taxation* 509 (Oct. 2015); Jarass and Obermair, "Tax on Earnings Before Interest and Taxes Instead of Profit — Fair, Simple and Competitive," 17(3) *EC Tax Rev.* 111 (June 2008); Jarass and Obermair, *Angemessene Unternehmensbesteuerung* (2017).

⁵If they have double taxation agreements with the respective member state.

⁶Council Directive 2003/49/EC (EU interest and royalty directive).

II. No Withholding Tax Relief at Source

Why should withholding tax for every payment be paid to the domestic tax administrations without any relief at source? Because relief at source supports tax fraud as well as base erosion and profit shifting.

The current exemptions as well as refund procedures for withholding tax can be abused in large-scale tax fraud schemes known as cum-ex and cum-cum. In addition, such withholding tax relief mechanisms for cross-border payments have proved to be lengthy, resource-intensive, and costly for both investors and tax administrations because of the lack of digitalized procedures and the existence of complex and divergent forms across member states.⁷

The establishment of a full-fledged, common EU relief-at-source system⁸ also would support BEPS. Increasingly in the last few decades offshore financing from banks and other financial institutions has become one of the favorite tax avoidance strategies for multinational enterprises. The part of their earnings paid as interest for credits or as license fees and transferred abroad is currently exempt from taxation in the withholding country, at least in the most relevant industrial ones. Once abroad, using the channels available for large international enterprises, the payments can easily be transferred to a tax haven. Relief at source, therefore, thwarts the basic idea of withholding taxes.

All these problems can be avoided by this author's proposal, which ensures that all withholding taxes paid to foreign tax administrations are issued a tax credit by the European member state where the income is declared and taxed.

III. Renegotiate Double Tax Treaties

For a (re)introduction of withholding taxes the double taxation agreements would have to be

adapted step by step. The OECD's BEPS action 15 provides a multilateral instrument for consensus to be achieved between the participating countries by a simultaneous change to all respective double taxation agreements.

When discussing the double taxation agreement, it is solely within the foreign country's discretion to decide:

- whether it introduces a withholding tax for interest and license fee payments to the respective EU member state; and
- whether it reimburses payees located in its country for withholding taxes paid abroad.

Compared with the complex, time-consuming, and costly current practices for the imputation of withholding taxes, this rather radical step will eventually make taxation much simpler and more efficient. Initially, however, this measure would require the renegotiation of double tax treaties, which currently do not allow adequate withholding tax rates.

IV. Consistency With EU Directives

Such a withholding tax concurs with all EU directives and complements the European Commission tax proposals. A unilateral withholding tax is explicitly allowed with some minor restrictions in the relevant EU interest and royalty directive. Taxation at source of all earnings produced by an enterprise, whether declared as profit or transferred to another enterprise, domestic or abroad, as payment for interest or license fees, was and is not generally forbidden by the interest and royalty directive. In fact, quite the reverse: As clearly stated in the directive, its aim is to prevent double taxation, while at the same time guaranteeing that all income is taxed once within the European Union.⁹

⁷ European Commission, *supra* note 2.

⁸ Withholding tax relief at source has been proposed by option 2, European Commission, *supra* note 2. See also EU Science Hub, "EU-Wide System for Withholding Tax Relief." The action plan for fair and simple taxation supporting the recovery strategy proposes to introduce a common, standardized EU-wide system for withholding tax relief at source.

⁹ "It is necessary to ensure that interest and royalty payments are subject to tax once in a Member State." EU interest and royalty directive.

The interest and royalty directive applies only to payments between associated companies, which generally refers to companies where one has at least a 25 percent direct minimum holding of the other.¹⁰

In addition, the directive provides for an exemption only upon request for every contract:

- For exemption, the source state may require for every payment an attestation to substantiate the fulfilment of the directive's requirements¹¹ and the legal justification for the payments (for example, loan agreement or licensing contract).¹²
- The source state may make it a condition for exemption that it has issued a decision granting the exemption following the attestation. If the paying company or permanent establishment has withheld tax at source to be later exempted, a claim may be made for repayment of that tax at source.¹³

In summary, withholding taxes can be implemented by any individual EU member state; in very rare cases withholding taxes must be repaid on individual request. To avoid these very rare cases, and thereby decrease the administrative burden on taxpayers, a clarification in the interest and royalty directive could be helpful. One such example is to define a general withholding tax of, say, 15 percent.

¹⁰EU interest and royalty directive, article 1, para. 7, in connection with article 3, para. 1b. Note that a minimum holding of 10 percent holds only for the EU parent-subsidiary directive (Council Directive 2011/96/EU), which is relevant for dividend payments.

¹¹EU interest and royalty directive, article 1, para. 11, in connection with article 1, para. 13.

¹²EU interest and royalty directive, article 1, para. 13, last sentence: "Member States may request in addition the legal justification for the payments under the contract (e.g. loan agreement or licensing contract)."

¹³EU interest and royalty directive, article 1, para. 12.

V. Tax Revenue for Participating Countries

The proposed withholding tax increases the tax burden only for those EU member states that use tax havens or low-tax regimes. The treasury of EU member states enforcing such reforms will increase their tax revenues. For example, Germany would have an additional net revenue of several billion euros annually, even if the foreign withholding tax on payments going into Germany would be completely refunded by the German tax administration.

Even if in the beginning the revenue increase would be less, the reform would counteract the trend of ever-growing tax avoidance, namely:

- the growing tendency of double nontaxation would be reversed, the advantage of tax avoidance countries would be reduced, tax havens would become less attractive; and
- the tax advantage of multinationals over small and medium-size enterprises and the resulting unfair competition would be reduced.

VI. Enables International Tax Harmonization

Without powerful measures, an ever-growing share of the earnings of big businesses will no longer be taxed anywhere and many EU member states with normal tax rates will lose more and more revenue in the long run. Businesses still residing there would be forced to move their headquarters (and the respective highly paid jobs) to low-tax countries within and outside the EU. All these tendencies can be reversed with the implementation of the measures outlined above.

Once a group of EU member states takes the initiative for a withholding tax it becomes easier for other countries to follow and join the struggle against tax avoidance. By increasing the number of countries in this manner, a step-by-step, de facto international harmonization is enabled. ■