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Frans Vanistendael

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The EC draft directive on interest from savings from a perspective of International Tax Law

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1. Introduction

EC harmonization of income taxes may be considered as an attempt to obtain an ideal level of efficiency in interstate tax relations.¹ The progress of this income tax harmonization in a common market or a monetary and economic union would mean a new step in the regulation of interstate tax rules (rules of limitation of law), especially because it exceeds the bilateral level of the existing tax treaty rules.

However, application of Art. 94 of the EC Treaty (ex-Art. 100) has not proved to be a very efficient instrument and partial harmonization of income tax may not be the most adequate procedure to deal with the question. A step-by-step harmonization, together with the active role of the ECJ and double taxation conventions may result in inconsistent bilateral regimes within the European Community.² In this sense the balanced regime proposed by the OECD Model could be adapted to the EC income tax relations. Although recognizing the impossibility of approving a multilateral treaty EC Model at this stage as proposed by the Segré Committee, a EC Model tax convention could be a possibility.³

At present, the aims of EC capital income tax harmonization and OECD tax recommendations tend to coincide or at least to come very close to agreeing. The classical aims of international tax law of reducing double taxation and tax evasion/tax avoidance remain as the basic objectives and mutual assistance between tax administrations is increasingly regarded as a fundamental instrument.

Our aim in this article is to analyze the regime of the Savings Draft Directive, compare it with the solutions of the OECD Model Convention and anticipate some problems of application of the Directive together with double taxation conventions. We are of the opinion the result would certainly be more consistent if some kind of EC Model tax convention were adopted. Finally, this analysis may also show the regime proposed in the Savings Draft Directive and subsequent technical and political discussions as an example that the European Community may not isolate tax harmonization from tax measures with third countries. This recognition is expressed in Art. 11 of the savings draft Directive.⁴

2. Explanatory notes on the Savings Draft Directive in comparison to OECDMC

2.1. Savings income in the form of interest payments as tax object

2.1.1. Adoption of an autonomous concept of interest and its interpretation

In the agreement obtained in the ECOFIN 1 December 1997, the original draft 'destined to assure a minimum of effective taxation of savings income ...' suggested the so-called co-existence model which apparently aimed at satisfying the different interests of Member States. As it is known, it is a proposal aimed at a 'minimum of effective taxation' because it is aimed

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¹ Although even in monetary and economic unions sovereign tax policies could maintain some autonomy: William Molle, *The Economics of integration, theory, practice, policy* (Aldershot, 1990) p. 170.

² See Moris Lehner, 'EC Law and the competence to abolish double taxation', *Tax Treaties and EC Law* (London, The Hague, Boston, 1997), p. 3. The author argues that Member States should have a predominant role in respect of interstate tax law regulation. Besides, M. Lehner considers the Commission in 1990 changed its policy, responding to double taxation problems but remaining 'far behind the suggestions in the Ruding Report, which recommended a more comprehensive harmonisation of substantive corporate income tax law' (p. 7). Regarding the relation between tax treaties and EC law, see also Luc Hinnekens, 'Compatibility of bilateral tax treaties with European Community law. The rules', *EC Tax Review* 1994, no. 4, p. 146.

³ The proposals made by the different EEC/EC reports on tax harmonization identify its priorities, but were only partially approved. If we compare the Neumark (*EEC reports on tax harmonization* (Amsterdam, 1963)) and Segré reports (*Le développement dans le marché européen des capitaux* (Bruxelles, 1966)) with the Ruding report (*Conclusions et recommandations du comité de réflexion des experts indépendants sur la fiscalité des entreprises, Commission des Communautés européennes* (Bruxelles, Luxembourg, 1992)) and the Monti report (*Taxation in the European Union* (SEC 96)487 final, 20 March 1996, Brussels)), we may conclude there is no substantial change in respect of the identified priorities of harmonization, although the suggested measures are not the same (see Moris Lehner, no. 2 above, p. 9).

⁴ Frans Vanistendael, 'Impact of European tax law on tax treaties with third countries', *EC Tax Review* 1999, no. 3, pp. 167-169.

only at individuals (Art. 1, n. 1). It suggested a co-existence model as it allowed an option to the state of establishment of the paying agent (of the interest to a resident individual in another Member State) between 'transmission of information to the Member State of residence for tax purposes of the beneficial owner of the payment' or 'for the levy of a withholding tax' (Art. 2, n. 1) of at least 20 per cent (Art. 8, n. 1).

The Savings Draft Directive aims at adopting a global concept of interest, excluding as far as possible exceptional regimes which would distort the internal market. Thus, in its Art. 5, the Draft Directive adopts an autonomous concept in relation to domestic rules. There is only a partial correspondence between the concept of the Draft Directive and the one contained in the OECD Model Convention, but since 1977 the OECDMC also adopts an autonomous concept of interest, abandoning the subsidiary remittance to domestic law as it resulted from the OECDMC 1963.

Contrary to the domestic law of Member States in which taxation of interest is included in the category of capital investment income,⁵ the Draft Directive, as well as the OECDMC, treat interest as an autonomous category. In international tax law, autonomy is demanded by reasons of clearness. As a matter of fact, the independent concepts of dividends, interest and royalties introduced by the OECDMC and the (albeit small) differences among the respective regimes, justify and recommend separated treatment of each category. This option also reveals an evolution in international tax law since the London Model Convention, as the Mexico Model Convention still considered both interest and dividends 'income of movable capital' in Art. IX of the Convention completed by Art. IX of the Protocol.^{6,7}

At the EC harmonization level, autonomy of dividends and interest regulation is recommended by reasons identical to those of the OECDMC and taking into account that directives do not aim at harmonizing all regimes of income taxation, separated negotiation appears as an attempt at more efficient procedure. However, in the OECDMC the different categories may be confronted and the respective concepts may be delimited. Furthermore, the Commentaries allow or help to decide if certain income should be qualified as interest or dividend in case of doubt.⁸ None of these two procedures normally occur when an EC directive raises interpretation questions. Thus, due to the aforementioned lack of a global income tax harmonization and if there is neither an explicit remittance to double taxation conventions nor to domestic law⁹ interpretation, doubts may only be solved by the ECJ.

As a novelty of the most recent EC draft directives on taxation we may find commentaries to the Articles that are similar to the OECDMC commentaries in its presentation form and contents. However, they are more condensed and resemble, in presentation, a preamble.¹⁰ The juridical value of these draft directives commentaries may be problematic whether or not they will be included in the approved text of the directives. In case they are included in the directives, we tend to consider those commentaries as part of their context (if we consider the context of directives embraces the

text, preamble and annexes as happens in the case of international treaties). As a consequence they will be binding elements of interpretation. The discussion about the exact qualification of OECDMC commentaries according to Arts. 31 and 32 of the Vienna Convention is broadly known, and while some Contracting States and authors consider them as 'interpretation aids', others qualify them as 'part of the context or supplementary means of interpretation'.¹¹ This discussion occurs exactly because they are not included in the approved texts of the bilateral conventions and have 'a general character'¹² and, therefore, some Contracting States do not recognize them as having binding effect. If the previously mentioned commentaries to the Savings Draft Directive are not included in the Directive it will be difficult to justify their binding effect. On the one hand, there is no rule in the EC Treaty about this subject and, on the other hand, the ECJ jurisprudence indicates they will be considered irrelevant, as long as they have no expression in the approved text of the Directive.¹³ We think however, that the just mentioned jurisprudence

⁵ Normally, movable capital income (although for example in Spain, immovable capital income is also part of the category).

⁶ See commentary to Art. VIII of London and Mexico Model Convention, League of Nations - Fiscal Committee, London and Mexico Model tax conventions, commentary and text (Geneva, 1946), p. 24. According to Art. IX of the Protocol to the Mexico Model Convention, 'the term "income of movable property" includes income of public funds, bonds, deposits, fixed or in current accounts, income of shares and similar parts in companies, as well as income of silent partners or shares of shareholders without management powers or personal responsibility in partnerships' (author's translation from the French).

⁷ This evolution may also be noticed in relation to previous studies in which the identical economic nature of interest and dividends was pointed out: League of Nations, Economic and Financial Commission, report on double taxation submitted to the Financial committee by Professor Bruins, Einaudi, Seligman and Sir Josiah Stamp (Geneva, 1923), pp. 36-37.

⁸ See, for example, commentaries to Art. 10, n. 3, s. 25 and Art. 11, n. 3, s. 19 of the OECD Model Convention.

⁹ As there is no similar rule to Art. 3, n. 2 of the OECD Model Convention.

¹⁰ To the effect of interpretation of international treaties, and therefore also of double taxation conventions, the preamble is part of the context and thus is also part of the main elements of interpretation of Art. 31 of the Vienna Convention. It is also recommended by the OECD Council that OECD Member States consider the commentaries as part of the context of bilateral double taxation conventions and not only 'preliminary materials' according to Art. 32 of the Vienna Convention: see n. 11 below.

¹¹ Klaus Vogel and Rainer Prokisch, 'Interpretation of double taxation conventions', *Cahiers de Droit Fiscal International*, vol. LXXVIII a, 1993, Generalbericht, p. 30. The OECD Model Convention commentaries may also be used by the Contracting States to confirm the usual meaning of an expression or concept resulting from the interpretation according to the 'object and purpose' of the Convention (see Arts. 31, n. 4 and 32 of the Vienna Convention): Rainer Prokisch, 'Auslegung von DBA', *Steuer und Wirtschaft International* 1994, no. 2, p. 54.

¹² Rainer Prokisch, see n. 11 above, p. 53.

¹³ According to the ECJ, it is permanent jurisprudence that declarations made during preliminary works that end up in the adoption of a directive may not be considered for interpretation purposes (having therefore no juridical relevance) when those declarations have no expression in the text of the rule: see *Fazenda Pública/Epson Europe BV*, C-375/98, 8 June 2000; *Antonissen*, C-292/89, 26 February 1991; and *Bautiaa and Société française maritime*, C-197/94 and C-252/94, 13 February 1996.

does not forbid the reference to the commentaries as a supplementary means of interpretation, in case the Directive contains general terms (vague predicates) explanations of which have been made in the commentaries and if the resulting interpretation does not contradict the 'object and purpose' of the Directive.¹⁴ However, the relationship among directives, double taxation conventions and eventually domestic law (through the remittance of Art. 3, n. 2 of the OECD Model Convention) becomes more complicated if the regime of the directive is not so detailed as the regime of the bilateral conventions, although there is coincidence in the object of regulation. Example of this complexity is the issue regarding the distinction between dividends and interest and of the possibility of deducting interest, as this article will discuss. The question depends on whether subsidiary recourse to the OECD Model commentaries is possible in order to interpret directive rules having the same wording in the bilateral conventions.

2.1.2. *Concept of interest according to Art. 5 of the Savings Draft Directive and to Art. 11, n. 3 of the OECDMC*

Article 5(a) of the Savings Draft Directive and Art. 11, n. 3 of the OECDMC

Article 5 of the Draft Directive defines interest in four paragraphs corresponding to subdivisions of the category. Only the first paragraph corresponds to the wording of Art. 11, n. 3 of the OECDMC, which does not differ from the domestic law concept of interest in the broad sense of 'remuneration received for making capital available' and 'income from debt-claims'.¹⁵ However, as Klaus Vogel mentions in respect of the OECDMC, payment of interest, as such, is a prerequisite to taxation in the case of the Draft Directive ('taxation of interest paid to individuals who have their residence for tax purposes in a member State other than the one where the payment is made' - Art. 1, n. 1), contrary to what normally happens in domestic law, as interest included in the amount of transaction of goods is domestically taxed as such.¹⁶ To the purpose of a double taxation convention, the hidden interest payments may be dealt with by Art. 21 OECDMC.

Thus, according to Art. 5(a) of the Draft Directive, interest means '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. Penalty charges for late payment shall not be regarded as interest'. To the effect of double taxation conventions, the wording 'income from debt-claims of any kind' must be understood in a broad sense, and the Draft Directive commentaries to Art. 5(a) do not exclude the same broad interpretation.

Income from debt-claims carrying 'a right to participate in the debtor's profits' although included

in the definition of interest may raise delimitation problems with the category of dividends. Under OECDMC commentaries 'debt-claims, and bond and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest', but 'where the participation in profits rests upon a provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of a loan and article 11 does not apply'.¹⁷ As Klaus Vogel further explains, it is neither a question of sharing the general hazard (such as the borrower's insolvency or the debt being irrecoverable) nor the hazard merely connected with the remuneration in question if the payment of interest depends on profits being made.¹⁸ Some criteria for determining relevant sharing of hazard, connected with determining thin capitalization, are pointed out in OECDMC commentaries to Art. 10, n. 3 (s. 25). In the same sense, commentaries to Art. 5 of the Savings Draft Directive refer, as a rule, income from debt-claims carrying rights to participate in the debtor's profits do not alter its qualification as interest, unless the lent funds effectively share hazards incurred by the debtor. The Draft Directive does not add any other commentaries to the subject, contrary to the aforementioned criteria established in the OECDMC commentaries. These also mention a trade-off criterion in case of doubt, considering the interest category (Art. 11) subsidiary in respect of the dividends category (Art. 10). It must also be stressed that, in case of a double taxation convention, one may apply the domestic laws criteria distinguishing both categories (Art. 3, n. 2 of the OECDMC) and identifying thin capitalization which are quite ample in some Contracting States and autonomous from general anti-abuse clauses.

Of course, the general term adopted in Art. 5(a) of the Draft Directive may not exclude the typological method of law application, and the implicit recourse to domestic criteria,¹⁹ although Community law does not predict such an explicit remittance. Klaus Vogel still indicates a decisive criterion applicable to double taxation conventions, according to which requalification of interest as dividends occurs when the loan according to the particular case and circumstances 'would not have been made available by a party dealing at arm's length'.²⁰

¹⁴ We may conclude in this sense making an interpretation 'a contrario' from what is referred to in the *Epson Europe* case.

¹⁵ Klaus Vogel, 'DBA - Kommentar' (München, 1996) (commentaries to Art. 11, n. 3), s. 56; Alberto Xavier, *Direito Tributário Internacional*, (Coimbra, 1993), p. 471.

¹⁶ Klaus Vogel, see n. 15 above, s. 57.

¹⁷ See OECD Model Convention commentaries to Art. 11, n. 3, ss. 18 and 19.

¹⁸ Klaus Vogel, see n. 15 above, s. 60.

¹⁹ In the sense of Arthur Kaufmann, *Grundprobleme der Rechtsphilosophie* (München, 1994), p. 111: as the majority of legal concepts do not fulfil the prerequisites of determinacy that would allow automatic/logical application to the case, typological and analogical thought is used by the interpreter.

²⁰ Klaus Vogel, see n. 15, s. 63 (c) and (d).

In any case, it is important to stress that, as a rule, income resulting from debt-claims will be taxed as interest under the EC (Draft) Directive as happens under double taxation conventions.²¹

Deduction of interest payments is not ruled by the Draft Directive, which means that deduction will be guaranteed under double taxation conventions according to Art. 24, n. 4 of the OECDMC. On the other hand, in case of hidden distribution of dividends, the portion corresponding to interest will be taxed under the Directive whereas the remaining amount will be subject to the double taxation conventions regime.

'Penalty charges for late payment shall not be considered as interest' both under Art. 5(a) of the Draft Directive and Art. 11, n. 3 of the OECDMC. However, to the effect of the Directive this regime will be binding, no reference being made in the commentaries to such payments, while the commentaries to the OECDMC allow Contracting States taxing such income as interest.²² Justification for not considering penalty charges as interest lies in their characterization as 'special forms of indemnity',²³ and they must be taxed according to the residual clause of Art. 21 of the OECDMC.²⁴ Remuneration for other services, such as a bank guarantee fee, is not covered in the definition of interest under neither the Draft Directive nor the OECD Model.²⁵

We still want to make a short commentary to the wording 'public debt securities' that is mentioned in the original version of the Draft Directive. This wording is also included in the Portuguese (and French) versions of the OECDMC, but not in the English one which refers to 'government securities'. The scope of interest income under the Directive will not be the same according to the first or the second wording. As it is known double taxation conventions 'neither generate a tax claim that does not exist under domestic law nor expand the scope or alter the type of an existing claim'.²⁶ They just distribute the right to tax at source and residence states if they really tax the income items ruled by the conventions. Using the words of Alberto Xavier in reference to double taxation conventions 'a valid taxation does not only depend from a treaty rule that allows it; it is still necessary an internal rule that imposes it'.²⁷ The result is not the same under EC directives that, besides distributing tax powers between the source and the resident Member States, create tax obligations and thus EC harmonization beyond limiting the territorial dimension of tax sovereignty also limits its material or legislative dimension.²⁸ This means the Savings Draft Directive distributes internal powers of taxation of interest accruing to non-residents and simultaneously creates an obligation to tax if the Member State of the paying agent opts for the 'withholding tax system', and an obligation to transmit information if the Member State of the paying agent opts for the 'information system'.²⁹ Therefore, it is significant whether Art. 5(a) refers to 'public debt securities' or to 'government securities'.

Article 5(b) of the Draft Directive

According to Art. 5(b) of the Draft Directive, the concept of interest includes 'the increase in value of

debt-claims in respect of which the income, by contract, consists, wholly or partly, of that increase in value, irrespective of the nature of that increase. The interest to be taken into consideration in such circumstances is the difference, paid by the paying agent on redemption, between the capital reimbursed and the issue price of the corresponding securities'. These situations were already included in (a), as well as in Art. 11, n. 3 of the OECDMC, but according to the commentaries of the Draft Directive, the autonomous reference to such income aims at eliminating possible doubts concerning for example, inclusion of income from zero coupon bonds and stripped bonds (every income resulting from the difference between the amount received on the redemption moment and the issue price). Those income amounts are qualified as interest although capital gains are included as long as they are paid by the paying agent on redemption of bonds (as is recognized in the Draft Directive commentaries). Another question refers to the qualification of income resulting from alienation of bonds to a third person which, according to the OECDMC and to domestic legislation of many Member States, is qualified as capital gain and accordingly taxed or exempted (it may also be qualified as profit or 'other income' under Art. 21, of the OECDMC).³⁰ But even within domestic laws we may sometimes find different tax treatment of zero coupon bonds and stripped bonds. However, for the purposes of the Savings Directive, and as a specific anti-abuse clause, it is important to tax anticipated alienation of bonds independently of the nature of the bond. An option has to be made between taxation of full gain realized upon sale or redemption and taxation of the amount of any discount corresponding to the period for which the bond is held. If the first solution is chosen it must be decided if capital gain is always taxed or only in case of tax evasion/tax avoidance.

As both taxation of interest or capital gains imply high costs to paying agents, namely if they have to consider the price of acquisition, the choice is difficult. However, if capital gains are taxed in the case of anticipated alienation (taxation of the seller) and final redemption is taxed as interest (taxation of the buyer), interstate double taxation may occur if a withholding tax is levied in both Member States where paying

²¹ Klaus Vogel, see n. 15, s. 63.

²² Under double taxation conventions celebrated by Portugal these penalty charges are charged as interest.

²³ See OECD Model Convention commentaries to art. 11, n. 3, s. 22.

²⁴ This is the interpretation of Klaus Vogel, see n. 15 above, s. 59.

²⁵ Klaus Vogel, see n. 15 above, s. 68.

²⁶ Klaus Vogel, n. 15 above (commentaries to the introduction), s. 46.

²⁷ Alberto Xavier refers to the 'principle of negative effect of treaties' (*Direito Tributario Internacional*, p. 112).

²⁸ Ana Paula Dourado, *A Tributação dos rendimentos de capitais: a harmonização na Comunidade Europeia* (Lisboa, 1996), pp. 17 and 31.

²⁹ We are considering of course the original version of the Draft Directive.

³⁰ See commentaries to Art. 11, n. 3 s. 20 of the OECD Model Convention.

agents are established. In order to avoid international double taxation the same criterion must be applied. We may still mention that to deal with this question of anticipated alienation of bonds, transposition of the internal methods to the Directive is very onerous to paying agents. Examples are the Austrian, Italian and German regimes,³¹ according to which the seller is taxed for the intermediate interest and the buyer (being taxed for the whole income) receives a tax credit.

In any case, independently of the regime adopted, the difficulty of taxing anticipated selling of bonds among individuals (transfer of bonds by paying agents but without any payment) is recognized.

In respect of swaps and other new financial instruments they are neither mentioned in the Draft Directive nor in Art. 11, n. 3 of the OECDMC. The 1995 OECDMC commentaries expressly exclude income of those instruments from the concept of interest to the purpose of double taxation conventions.

Article 5(c) and (d) of the Draft Directive

Article 5(c) includes in the concept of interest 'income distributed by undertakings for collective investment in transferable securities within the meaning of Council Directive 85/611/EEC which invest directly or indirectly more than 50% of their assets in debt-claims or corresponding securities'. It is different from OECDMC which does not explicitly mention these revenues. This omission in the Model Convention creates difficulties for collective investment undertakings that are not 'companies' (corporate bodies or entities treated as such) and therefore may not be qualified as 'persons' for the purpose of Art. 1 of the OECD Model Convention. Thus, for the purpose of avoiding double taxation of income distributed by these collective investment undertakings, its inclusion in the Draft Directive is positive. Moreover, taking again into account the fact that EC directives create tax obligations, it was important to adopt an exhaustive concept of interest in order to avoid tax induced distortions.

However, Art. 5(c) raises many critiques, and this article summarizes some of them. On the one hand the quantitative criterion of 50 per cent adopted to submit income from funds to the Directive treats as interest other categories of income obtained by such funds, which does not happen either according to domestic laws or to double taxation conventions; on the other hand, in case collective investment undertakings are companies, some distributions may not be treated as dividends, but the distinction would certainly cause distortions; let us still mention that the quantitative criterion of 50 per cent is an invitation to alter composition of investment instruments. Therefore, taxation according to a 'look through' principle appears to be more rigorous, although burdensome to paying agents.

Article 5(d) broadens the scope of the previous point (c), in order to avoid distortions resulting from capitalization of investment funds income. Thus it is interest 'the difference between the redemption price

of units in undertakings referred to in point (c) and the issue price of those units or, if the units are purchased by the beneficial owner after issue, the purchase price'. However, if the underlying aim of point (d), according to the commentaries, is to avoid non-taxation of capitalized income of funds, taxation of full gain causes discrimination of this income.

2.2. Concept of beneficial owner

The concept of 'beneficial owner' (*bénéficiaire effectif* in French, *beneficiário efectivo* in Portuguese, *Nutzungsberechtigte* in German), introduced in the OECDMC in 1977, has been used in double taxation conventions to control tax abuse and to justify restriction of domestic tax power. In fact, payment of dividends, interest or royalties to the beneficial owner resident in a Contracting State, induces application of the treaty rules, limiting the right to tax of the source state. On the contrary, payment to an intermediary resident in a Contracting State excludes restricted taxation in the source state.³²

As is explained by Klaus Vogel in his commentaries to the OECDMC, the concept of 'beneficial owner' was not commonly used before its introduction in the Model, even though we may find previous and posterior references to the concept, with regard to application of both domestic and treaty rules.³³ All those references share the idea that 'legal property' is not sufficient but 'economic property' must co-exist, the 'substance' being decisive over the 'form'. According to Vogel, 'the 'beneficial owner' is he who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields therefrom should be used or (3) both'.³⁴

Furthermore, although it is not legitimate to apply domestic law in order to clarify the meaning of the expression, as its origin does not lie in domestic laws, we are of the opinion the absence of a total coincidence of the term in the different languages induces a reciprocal interpretation of the expression.

All in all, the 'beneficial owner' is not necessarily the legal owner of the right originating the income; a usufructuary or a trustee may also be beneficial owners.³⁵ However, factual limitations to disposition power in the case of individuals are very difficult to prove³⁶, which raises serious problems in the case of the Savings Draft Directive, as it restricts the concept of 'beneficial owner' to individuals: 'any individual who

³¹ Even though the regimes differ in respect of the tax credit attribution moment.

³² See commentaries to Art. 11, n. 2, s. 9 of the OECD Model Convention.

³³ See Klaus Vogel, n. 15 above, s. 7 of the commentaries previous to Arts. 10, 11 and 12 of the OECD Model Convention.

³⁴ See Klaus Vogel, n. 15 above, s. 9 of the commentaries previous to Arts. 10, 11 and 12 of the OECD Model Convention.

³⁵ See Klaus Vogel, n. 15 above, ss. 8 and 9 of the commentaries previous to Arts. 10, 11 and 12 of the OECD Model Convention.

³⁶ See Klaus Vogel, n. 15 above, s. 10 of the commentaries previous to Arts. 10, 11 and 12 of the OECD Model Convention.

receives an interest payment for his own benefit' (Art. 3(a)).

Taking into account the above-mentioned restriction, the concept of the Draft Directive corresponds in its essential aspects to the OECDMC. However, the main purpose of the expression in the Draft Directive is not to protect the beneficial owner from (double) taxation but instead to confine taxation of interest income within the Savings Directive to '(individual) beneficial owners'. As mentioned in the commentaries to Art. 3(a) of the Draft Directive, payments of interest in favour of companies as well as in favour of intermediate individuals acting as agents or authorized persons, are excluded from its scope. We may then ask if double taxation conventions are applicable to the remaining beneficial owners and to agents. In the case of payments made to an intermediary the regime of tax treaties may lead to a result contrary to the purpose of the Draft Directive, if the state of source (in this case, of the debtor) effectively taxes non-residents interest.

The result may be worse if connection elements 'paying agent' used by the Draft Directive and 'debtor' used in the tax treaties are jointly applied. Thus, for example, interest paid by Luxembourg to an intermediary resident in France, owed by a debtor resident in Portugal may be taxed in Portugal without limits (Art. 11, ns. 2 and 5 of the OECDMC) and also in France (Art. 11, n. 1 of the OECDMC). If the intermediary is a paying agent for the purposes of the Draft Directive, and Luxembourg has opted for the withholding system, he must withhold an amount of 20 per cent.

To avoid the situation of double taxation we could suggest that, considering the aim of the Draft Directive, double taxation conventions must not be applied to the intermediaries of individual beneficial owners, but this interpretation may not be deducted from the Draft Directive. In fact, Art. 8, n. 1 of the Draft Directive only forbids 'other withholding tax ... levied within the Community on interest paid to beneficial owners' and commentaries only refer that prohibition of other withholding taxes on interest payments comprised in the Directive is valid to all Member States (including those opting for the information system).

Another question respects the inclusion or not of partnerships and interest connected with the activity of sole traders in the scope of the Draft Directive. Taxation of sole traders seems to us more problematic as it leads to discrimination according to the juridical form of the activity. Moreover, a permanent establishment of a sole trader would be taxed and this is both against the principle of permanent establishment of international tax law and freedom of establishment in Community law. The only solution would be to reject the sole trader as the beneficial owner and to consider the permanent establishment to which the debt-claim is connected as the beneficial owner. This would mean the non-application of the Directive rules.

In any case, besides being an interesting question to analyze, the principle of 'reservation of permanent establishment' in international tax law is especially relevant to the case of dividends and royalties, as interest income of permanent establishment is only

significant in the case of non-resident financial or security companies.³⁷ As the Draft Directive only covers individuals (and eventually respective permanent establishments) the above-mentioned problems will not be very relevant.

2.3. The aims of the Draft Directive and the option for the co-existence model

In the exposition of motives of the Savings Draft Directive, presented in 1998, in the sequence of the ECOFIN of 1 December 1997, reference is made to its inclusion in a packet of measures against harmful competition in tax matters in the European Union, suggested by the Commission to 'reduce distortions subsisting in the internal market, avoid important losses of tax revenues and orientate tax structures' in a more favourable direction to employment.

As we have just mentioned, the present proposal only covers interest obtained in a Member State by individuals resident in another Member State. Within the same direction of a minimalist harmonization, and as already mentioned, the original version of the Draft Directive introduced an optional regime. In the sequence of the agreement in Santa Maria da Feira last June, the information system is now proposed as the regime rule, the withholding by the paying agent being only exceptionally and temporarily admitted. An option is now clearly made in favour of the residence member state.

In international tax law, namely in the OECD Model Convention, the regime of interest, dividends and royalties is very similar because it is considered they integrate the broader category of capital investment income and thus the *ratio* of attributing competence to states must be the same. As mentioned above, the autonomous rules are recommended for systematization reasons. Contrary to what happens with other categories of income, where taxation is either attributed to the source or the residence state, a compromise solution was proposed to these investment income items. The state of source has priority in taxation but is limited to tax a certain percentage, and the state of residence taxes the biggest amount of the income, and must attenuate/eliminate double taxation. Distribution of taxing power to both states is justified by the fact that the invested capital has its origin in the residence state and the state of source is the state that provides the infrastructures and workers.³⁸ However, in the commentaries to the OECDMC, exclusive taxation in the residence state is considered to be more legitimate as the state of source already has the possibility of taxing the profits (Art. 10, ss. 6 and 9 of the OECDMC commentaries). The trend in negotiations of OECD bilateral conventions has been to follow this line of reasoning, with some exceptions, as in the case of Portugal.

³⁷ Klaus Vogel, see n. 15 above, s. 15 of the commentaries previous to Arts. 10, 11 and 12 of the OECD Model Convention.

³⁸ Klaus Vogel, see n. 15 above, s. 2 of the commentaries previous to Arts. 10, 11 and 12 of the OECD Model Convention.

Nevertheless, the argument referred in the OECDMC commentaries, in favour of exclusive taxation of interest by the residence state, is not consistent. If we observe the evolution of proposed solutions in the first double taxation treaties and several model conventions, as well as in the presently existing models, we verify an enormous oscillation in the attribution of revenues either to the source or to the residence, according to the prevailing interests of capital importing or capital exporting countries in the draft of those models.³⁹

In the first double taxation treaties concluded before World War I between the Austrian-Hungarian empire with states of the German empire, and in the Convention on Common Principles of 1921 concluded among Austria, Italy, Poland, Kingdom of the Serbs, Croats, Slovenian and Romania, was adopted the principle of the state of production having the primary right to tax. Movable capital income was subject to 'real taxes' in the 'source' state.⁴⁰ That same income would acquire 'personal character' in the residence state and then be subject to double taxation, although this should be attenuated by the mentioned residence state.⁴¹ However, in the report of the group of economists of the League of Nations (1923), where source and residence were chosen as the main elements of connection, the residence state should tax immovable property, commercial establishments, agricultural materials and machinery.⁴² In the US, in the late 1920s, it was considered that the source state had the right to tax movable capital income.⁴³ According to the Mexico Model Convention, interest, as income from movable capital, should be exclusively taxed by the source state, whereas the London Model Convention attributes a compromise taxation to the source and residence states; the right of the source state should be limited to a mutually agreed percentage.⁴⁴ In the commentaries of the League of Nations to both Model Conventions, reference is made to the special complexity of distribution of tax powers in the case of dividends and interest income, and it is further considered that exemption by the source state should be weighted with the counterpart resulting from increase in foreign investment and in economy.⁴⁵

Comparing the present solutions to capital investment income in the different model conventions, we conclude the proposed regimes continue to differ.⁴⁶ It is true that distribution of tax power in respect of other categories of income is also controversial, and that the perspectives of the states participating in the elaboration of the model conventions determine the proposed solutions. However, we may say that within the OECDMC, rules regulating other categories, except capital investment income, have attained a minimum level of juridical justification beyond political reasons, even though they are becoming obsolete due to globalization and regional integration.⁴⁷

In this context, the co-existence system proposed in the original version of the Savings Draft Directive appears as recognition of the lack of consistency of international tax law principles (source state versus residence state as the legitimate state to tax dividends)⁴⁸ and as a resigned acceptance of it. Let us just

remember the previous EEC Draft Directive suggested a final withholding tax system. Commentaries to Art. 8, n. 2 of the Draft Directive state that the withholding tax is not in principle a final withholding and does not discharge tax obligations in the residence country of the beneficial owner. The withholding tax is thought of as a practical instrument. We may say, however, these declarations would not be accomplished with the proposed regime of the original draft. According to Art. 8, n. 2, the beneficial owner may present 'to the paying agent a certificate drawn up in his name by the competent authority of the Member State in which he is resident for tax purposes' and in this case he would only be taxed in the residence state. This rule is of doubtful usefulness as many taxpayers would prefer to be taxed at a final rate of 20 per cent in the Member State of the paying agent.

On the other hand, although the original Draft Directive intended to conciliate the different interests of Member States, we may anticipate that the combination of both regimes in the EC would produce unbalanced results in respect of distribution of tax revenues within the Community, aggravated by displacement of income and revenues, especially in the direction of third countries.⁴⁹

The purpose claimed by the Commission of diminishing distortions within the Common Market

³⁹ See the discussion of the problem in Klaus Vogel, who tends to defend taxation by the state of residence of the debtor of interest (the source state) because it is the source state that provides the competition conditions to the results of the investment ('Worldwide vs. source taxation of income' *Intertax* 1988, no. 10, pp. 315-316).

⁴⁰ See Ana Paula Dourado, n. 28 above, p. 59; *Rapport et résolutions présentés par les experts techniques au comité financier de la société des nations* (1925), pp. 12-13.

⁴¹ See n. 40 above, pp. 13, 19-20.

⁴² See n. 40 above, p. 31.

⁴³ Edwin Seligman, *Double taxation and international fiscal cooperation* (New York, 1928), p. 42.

⁴⁴ League of Nations, see n. 7 above, pp. 26, 62, 65.

⁴⁵ League of Nations, see n. 7 above, p. 26.

⁴⁶ See Troya Jaramillo, 'La Fiscalidad internacional en la comunidad andina', *Curso di Diritto Tributario internazionale*, Coord. Victor Uckmar, (Padova, 1999), pp. 808 and 811. The author criticizes the orthodoxy of the Andin Model, namely decision 40 (1975), relating to taxes on income and property, for being too rigid in the defence of the source principle without adequate justification.

⁴⁷ See for example, Paul Farmer, 'EC law and national rules on direct taxation: a phoney war?', *EC Tax Review* 1998, no. 1, p. 13. Klaus Eicker, 'Tax efficient structures for electronic business. The challenge for corporate structures and business models', *Intertax* 2000, no. 3, p. 20; Toshiaki Katsushima, 'Internet and electronic commerce - the next frontier', *Intertax* 1998, no. 3, pp. 86-87.

⁴⁸ It must be stressed that Klaus Vogel defends source taxation (and tax exemption method) as the best solution to achieve neutrality: 'Harmonisierung des Internationalen Steuerrechts in Europa als Alternative zur Harmonisierung des materiellen Körperschaftsteuerrechts', *StuW* 1993, p. 385; see also, 'Worldwide vs. source taxation of income - A review and re-evaluation of arguments', *Intertax* 1988, nos. 8 and 9, pp. 227-229.

⁴⁹ Albert Rädler refers the risk of displacement of beneficial owners ('Comments on the interest directive proposal 1998', see n. 46 above, pp. 747-748). However, the risk of displacement of some capital markets, like the euro-bonds market and investment funds as well as the risk of displacement of paying agents seems to be much bigger.

may also not be accomplished by the co-existence model. Adoption of the 'information system' by some Member States would favour 'withholding tax system Member States' as transmission of information would not be dependent on reciprocity (Art. 7, n. 4). Reduction of tax distortions within an internal market requires a single system, which is, after all, the purpose of tax harmonization. Furthermore, the claimed objective of 'avoiding important losses of tax revenues' would be difficult to attain. As a matter of fact, the absence of an option in the attribution of revenues to the source or the residence state and the uncertainties on the resulting distribution of revenues among Member States according to the co-existence model, wrongly forgets the opposed interests of Member States. As it will be mentioned below, the Draft Directive introduces the 'paying agent' element in order to determine the source state. It is recognized that the paying agent reveals a very slight economic allegiance with the source state.⁵⁰ Therefore, there is a considerable risk of displacement of interest towards paying agents established in some Member States: Member States where the net output would be higher.⁵¹ The possibility of attribution of tax revenue to 'Member States of the paying agents', in the absence of a relevant economic allegiance according to the principles of international tax law, raises serious doubts about the proposed regime. The general purpose of avoiding losses of tax revenues, independently of choosing the addressee states, would only be justified if a relevant part of them were EC budget revenues, which is not the case. In this context, the information system as suggested in the agreement of Santa Maria da Feira seems to be a better solution than the coexistence model.

2.4. Taxation in the source state – paying agent versus debtor

The last item we want to mention refers to the paying agent element. In spite of the critiques we have just made to the 'paying agent' element, this was the only possible solution in the context of a proposal limited to taxing individuals and directed to an internal market where Member States are unable to tax interest income obtained by their residents abroad. In a way, the Draft Directive recognizes that the residence state depends on the 'source' state, either because the source state transmits relevant information or because it is in a better position of taxing the income.

The 'debtor' of the interest income, which in international tax law (OECDMC) is considered as an adequate element to determine source, is thus replaced. It should be pointed out that, in the English version of the OECDMC, the source state is the state of residence of the 'payer', an exception being made in all versions to debt-claims connected to permanent establishments or fixed bases. Contrary to the English version, the OECDMC in German, French and Portuguese versions refer to the debtor of interest (*Schuldner*, *débiteur des intérêts*, *devedor dos juros*). Independently of the language differences, the underlying idea is indeed the residence of the debtor (that may coincide with the

payer) as results from the commentaries of Klaus Vogel to Art. 11 of the OECD Model Convention (both in the German and the English editions). In the English edition, Klaus Vogel makes the linguistic correspondence, when he refers 'the payer (debtor) is he who owes the interest under private law', and only in the case of permanent establishments the economic criterion of payment may be used instead of the juridical criterion. Thus, only the debtor or an agent may (and must) withhold the due tax, 'and not some further person concealed 'behind' the debtor'.⁵² Underlying the interpretation of Vogel we find an aim of controlling tax abuse that might arise through the interposition of paying agents. Of course the opposite phenomenon may occur: interposed debtors with the purpose of tax evasion/avoidance.

The paying agent within the Draft Directive does not correspond to the 'payer' (debtor) in the OECDMC and has a different function. In the first place, within double taxation conventions, definition of source is not relevant when taxation occurs exclusively in the residence state.⁵³ For the purpose of the Draft Directive the source state plays the main role as it supposedly allows effective taxation of non-residents. 'Paying agent' is defined as '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 the beneficial owner, in cases where the economic operator is established within the Community outside the Member State in which the beneficial owner is resident for tax purposes' (Art. 3(b)). According to this definition, the decisive criterion is not owing the interest under private law, but 'owing the responsibility for the payment for the immediate benefit of the beneficial owner'. The main reason underlying this definition corresponds to the fact that only the paying agent may identify the (individual) beneficial owner. In this sense the commentaries to Art. 3(b) state the purpose of the definition as guaranteeing identification of only one paying agent. The indeterminacy of the definition and resulting problems in its application is, however, broadly recognized. In fact, it is very difficult to determine the last person/operator established within the Community charged with the payment when we verify a plurality of intermediate operators. The meaning of 'payment' is here decisive. What is meant by payment? Does it mean crediting, holding of assets by the paying agent, or a simple transfer of funds? Independently of the solution given many doubts will certainly appear in concrete cases. Another

⁵⁰ See definition of source and critique in Alberto Xavier, see n. 27 above, pp. 253-256; and Klaus Vogel, see n. 48 above nos. 8 and 9 pp. 227-229.

⁵¹ Regarding the relationship between benefits and burdens normally balanced by the taxpayer (administrative net output), see Klaus Vogel, n. 48 above, no. 10, pp. 313-315.

⁵² Klaus Vogel, see n. 15 above, commentaries to Art. 11, s. 93 (both in the German and English editions).

⁵³ Klaus Vogel, see n. 15 above, commentaries to Art. 11, s. 88.

related problem is the transfer of amounts to third countries and respective tax treatment. An anti-abuse clause should be introduced in the Directive.

All in all, the 'paying agent' is a reasonable element in a single system of information, or even in a system of withholding tax with redistribution of revenues to the residence state. Acting in such systems the paying agent would not provoke distortions in distribution of tax revenues.

2.5. Information system and taxation by the residence state

It is widely known that the ECOFIN of Santa Maria da Feira on 19 and 20 June 2000, formally rejects the co-existence model and opts for the information system, as had been proposed by the United Kingdom for several months.

The withholding system may be adopted in a transition period in Austria and Luxembourg but conditioned to redistribution of revenues to the residence state. Belgian, Greece and Portugal shall inform the Council about their position until the end of 2000. Furthermore, approval of the Directive depends on negotiations with the United States and other third countries (Switzerland, Liechtenstein, Monaco, Andorra and San Marino) promoting identical measures in such countries. Dependent and associated territories must be contacted with the same purpose.

The necessity of mutual assistance to international tax purposes was established since the first tax treaty models,⁵⁴ but obviously assumes a new dimension in present days, although it has not been effective until now.⁵⁵ Several restrictions contribute to this inefficiency: the limits resulting from the bilateral character of double taxation conventions, the clause of reciprocity established in Directive EEC 77/799, the absence of a sufficiently detailed regulation. This last aspect also characterizes the present Savings Draft Directive, and the conclusions of Santa Maria da Feira reintroduce, after all, the demand of reciprocity within the proposed Directive.

In any case, there is no doubt the systematic and automatic exchange of information in the Savings Directive would mean a higher level of interstate tax mutual assistance. At this stage of the discussion of political and technical questions, drawing of conclusions is difficult, but approval of the Directive would certainly mean a step forward in EC income tax harmonization.

⁵⁴ See for example, *Draft of a bilateral convention on administrative assistance in matters of taxation* (League of Nations, London 8 April 1927).

⁵⁵ See for example, Pietro Adonnino, 'Lo Scambio di informazioni fra amministrazioni finanziarie', n. 46 above, p. 891.

Fiscal support measures and harmful tax competition*

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1. Introduction

As an indirect result of the December 1997 approval of the European Code of Conduct to fight harmful tax competition,¹ the restrictions on fiscal support measures regarding income tax under Arts. 87, 88 and 89 of the EU Treaty attracted a great deal of publicity. The approval of the Code of Conduct and the two associated draft directives (on interest royalty and interest savings) are consistent with a tax policy, designed by European Commissioners Scrivener and Monti, which, in retrospect, can be regarded as a return to the basic principles of the EU Treaty.

At the time the Ruding Report was published,² it had already transpired that the large-scale plans for harmonization of income tax in general and corporate income tax in particular had been abandoned for good. Disruptions to economic transactions among the

Member States attracted most of the attention, as the Commission had a clear mandate in respect of the promotion of intra-Community trade, but much less clearly defined powers in respect of the overall harmonization of the tax systems. The approval of the Code of Conduct confirmed this trend, particularly since the fiscal support measures were systematically

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¹ A package to tackle harmful tax competition in the European Union, Communication from the Commission to the Council and the European Parliament, COM (97) 564 final 5.11.1997.

² Report of the Committee of Independent Experts on Company Taxation, Commission of the European Communities, March 1992, Brussels, Annex 10 A and 10 B.