New EU system to avoid double taxation for withholding taxes

Cross-border investment and simplified taxation are a priority for the EU. Nevertheless, cross-border portfolio investors still face obstacles regarding avoiding double taxation for withholding taxes. Therefore, the European Commission has started an initiative to introduce a common EU-wide system for withholding taxes on dividend or interest payments.

According to the European Commission, fair taxation and the fight against tax fraud are key foundations in an economy that works for everyone. The Commission aims to remove all barriers to the completion of the Capital Markets Union. In this context, fostering cross-border investment, tackling tax fraud and simplifying taxation feature high among the Commission's priorities.

The Commission has already undertaken various measures to address tax barriers to cross-border investment and the risk of tax abuse within the EU, such as the "Code of Conduct on Withholding Tax" published in 2017. The Code of Conduct has sought to introduce quick, simplified, and standardised withholding tax relief procedures that reduce the challenges faced by smaller investors when doing business cross-border.

Despite the Commission's actions, tax barriers persist and one remaining barrier is the problem of inefficient withholding tax relief procedures. According to the most recent publicly available data from 2016, costs related to withholding tax refund procedures, foregone tax relief and opportunity costs are estimated to be EUR 8.4 billion within the European Union. The Action Plan for fair and simple taxation supporting the recovery strategy, which was published in July 2020, has proposed introducing a common, standardised EU-wide system for withholding tax relief at source that is coupled with a new exchange of information and cooperation mechanism between tax administrations.

Withholding tax relief mechanisms for cross-border payments have proven to be lengthy, resource-intensive and costly for both investors and tax administrations due to the lack of digitalized procedures and the existence of complex and divergent forms across Member States. In some cases, these high costs drive non-resident taxpayers to forego their right to apply for the tax treaty benefits that they are entitled to, and so leads to double taxation and consequently to less attractive net returns than for domestic investments. This is particularly burdensome for individual and small investors, as they are regularly required to submit ex-post a refund claim for the excess tax withheld by the source country. The effort required with these refund procedures in various countries regularly outweighs the small amount of excess withholding tax. Individual tax administrations make this even more difficult due to complex formal requirements and additional requests communicated in a foreign language. This leads to investors avoiding investing in certain countries or (very reluctantly) accepting double taxation.

Inception Impact Assessment by the European Commission

On 28 September 2021, the Commission published an Inception Impact Assessment and asked for feedback by 26 October 2021. The initiative behind this assessment concerns the procedures for relief from the withholding tax for dividend and/or interest payments on investments made in the source country by a non-resident investor. To achieve this goal, the Commission is currently looking at the following three policy options:

Option 1: *Improving withholding tax refund procedures to make them more efficient.*

This option entails implementing several measures whose object is to simplify and streamline withholding tax refund procedures by making them quicker and more transparent. Examples of such possible measures include: the establishment of common EU standardised forms and procedures for withholding tax refund claims irrespective of the Member States concerned, and the obligation to digitalise current paper-based relief processes.

Option 2: *Establishment of a fully-fledged common EU relief at source system.*

This option entails implementing a standardised EU-wide system for withholding tax relief at source. Here, the correct withholding tax rate, as provided in the double tax treaty, would be applied at the time of payment by the issuer of the security to the non-resident investor and so would not incur double taxation.

Option 3: *Enhancing the existing administrative cooperation framework to verify entitlement to double tax convention benefits.*

This option envisages a reporting and subsequent mandatory exchange of beneficial owner-related information on an automated basis to reassure both the residence country and source country that the correct level of taxation has been applied to the non-resident investor.

The Commission's work on this initiative should lead to a directive, which is currently being planned to be adopted in the fourth quarter of 2022. The next step is a public consultation, which was originally planned for the third quarter of 2021, but has not yet been made public. The current status of the initiative can be found here.

Bottom line

The Commission's efforts to create a common system for withholding tax relief for dividend and interest payments are very welcome. The existing burden and the effort that investors currently face for achieving double taxation relief on their investments are in many cases disproportionate - especially for private investors - and, above all, regulated quite differently in the various national legal systems.

Among the options proposed, a system that is as simple as possible within the meaning of Option 2 and would allow a withholding tax relief at source in accordance with the respective double tax treaty would be preferable from an investor's point of view, irrespective of the size of the investment. However, this would mean additional compliance for the financial services industry.

It remains to be seen how Option 3, taken by itself, would make it possible to avoid double taxation. As we understand it, Option 3 can only achieve this goal in connection with either Option 1 or Option 2.

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