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**COMMISSION STAFF WORKING PAPER**

**EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT**

*Accompanying document to the*

**Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (recast)**

{COM(2011) 714 final}
{SEC(2011) 1332 final}

## EXECUTIVE SUMMARY

This impact assessment will accompany the proposal to recast Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States ('the Directive'). Directives 2004/66/EC, 2004/76/EC and 2006/98/EC and Annexes VI and VII to the Treaty of Accession of Bulgaria and Romania have amended the Directive by extending its application to companies and taxes in the new Member States and granting some of them temporary derogations from some of its provisions[1]. In order to simplify the applicable rules it is useful to merge all this legislation into a single legal text.

The benefits of the Directive are granted to companies which are subject to corporate tax in the EU, tax resident in an EU Member State and have one of the legal forms listed in the Annex to the Directive. It covers payments between associated companies, i.e. where one of the companies has a direct minimum holding of 25 % in the capital of the other company, or a third company has a direct minimum holding of 25 % in the capital of both the payer and the recipient company.

Article 8 of the Directive required the Commission to report to the Council on the operation of the Directive with a view to extending its scope. The report was presented on 23 April 2009 (COM(2009) 179) and concluded that legal amendments could be made to make the Directive function better and thus achieve its objectives more fully.

### Problem description

The main issue addressed by this legislation is the heavier taxation of cross-border capital flows than domestic transactions. In the case of international payments, the recipient pays corporate tax in its State of residence and an additional withholding tax charged by the State from which the payment is made (the source State). Tax relations between Member States are generally governed by double taxation conventions (DTCs) that may provide for the exemption or reduction of withholding taxes; also, the residence State may allow the taxpayer to reduce its corporate tax by granting it a tax credit linked to the withholding tax. The withholding taxes and the administrative procedures required for their relief impede the smooth functioning of the internal market. During the early 1990s, the Parent-Subsidiary Directive had harmonised the tax regime applicable to EU profit distributions[2]. Only in 2003 did the Council harmonised the tax regime applicable to cross-border interest and royalty payments between associated companies with a view to putting them on an equal footing with domestic payments by providing for the exemption of withholding taxes at source. Due to the different legislative procedures followed and the more recent amendment of the Parent-Subsidiary Directive in 2003, the scopes of the two instruments differ.

Concerning the scale of these problems, in 82 % of cases, both the parent company and the subsidiary have a legal form that falls under the scope of the Directive; nearly 95 % of royalty

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[1] OJ L 157, 26.6.2003, p. 49, OJ L 168, 1.5.2004, p. 35, OJ L 157, 30.4.2004, p. 106, OJ L 363, 20.12.2006, p. 129 and OJ L 157, 21.6.2005, p. 278 and p. 311.

[2] Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20.8.1990, p. 6, as amended by Directive 2003/123/EC, OJ L 7, 13.1.2004, p. 41.

payments and approximately 90 % of interest payments are covered by the Directive. As regards the association requirement, non-associated companies (0 to 25 % holding) represent 12 % of holding links. This initiative tries to solve some of the problems linked to cross-border payments that fall outside its scope:

- Cost-minimising firms try to avoid withholding taxes through tax planning: company groups may establish an intermediate conduit entity in a different Member State so that the payment received by it enjoys a tax exemption which would not be applicable otherwise. This can result in suboptimal choices driven not by efficiency but by tax factors; on the other hand, Member States lose tax revenues.

- Withholding rates vary in the different bilateral relations between Member States. Different DTCs may provide for different rates. This may distort economic decisions attracting investment to low tax countries.

- The conditions for enjoying withholding tax exemption under the Directive relating to the organisational form, the relations between the parties to the transaction, the ownership shares, minimum holding periods, etc. induce firms to choose options driven by tax factors instead of by efficiency criteria.

- The requirements to obtain the Directive's benefits are stricter than those established in the Parent-Subsidiary Directive for the exemption of dividends. The different tax regime for dividends, interest and royalties may distort the capital structure of companies and the allocation of intangibles.

- The application of withholding tax relief at source provided by DTCs involves administrative procedures imposing heavy administrative burdens and costs on firms. In many cases, it is provided only later via a refund. This results in liquidity costs. Also, if it is granted through tax credits in the residence State, there is a delay between the withholding charge and the deduction in the tax return. This also generates liquidity costs. These compliance costs for EU companies are estimated at €126 million each year.

- Companies will be subject to double taxation: they bear a levy at source and corporate tax in their State of residence. This latter State may provide for double taxation relief either by exempting such income or by allowing deduction of the tax charged at source. However, if the withholding tax charged on the gross payment is higher than the corporate tax (low nominal rates) calculated on the net income derived from such payment, the companies suffer higher taxation than that charged on equivalent domestic payments.

Another problem has to do with the conditions imposed for exemption from withholding tax when the payment is made by a company through a permanent establishment, i.e. a branch: such payment has to be a tax-deductible expense for this taxpayer. As it is currently worded, the Directive would not apply to cases where deduction is denied on grounds such as failure to comply with all the formal requirements, while the transaction is effectively connected to the activity of the permanent establishment.

Finally, the Directive does not require the exemption at source to be linked to taxation of the payment in the residence State of the recipient. This may lead to payments free of tax. At the

time the Directive was agreed, the Council invited the Commission to propose the necessary amendments. The Commission adopted an amending proposal, COM(2003) 841, to exclude from the withholding tax exemption companies already exempted from tax on interest and royalties received in their residence State. While there was general consensus on a compromise text, the discussions in the Council working groups between 2004 and 2006 did not result in a unanimous agreement. The Commission withdrew this proposal when it adopted the Communication 'Commission Work Programme 2010 — Time to act', COM(2010) 135 final, because it planned to propose this new recast of the Directive.

Maintaining the current scenario would perpetuate distortions of business behaviour, compliance costs for companies and the risk of double taxation. As a consequence, there would be less cross-border capital flows, reducing capital and technology transfers. The process of cross-border allocation of resources would be adversely affected. In sum, the potential of the internal market would not be achieved.

In principle, this situation affects companies of all sectors and sizes, although compliance costs constitute a larger share of the total cost for smaller firms. Concerning interest, the problems addressed here affect mainly the financial sector. Still, the capital structure of corporate groups in any sector of activity is composed of equity and debt. This means that all sectors of activity are affected. Concerning royalties, sectors intensive in the use of technology and intellectual rights face these tax burdens more frequently.

Tax administrations are also affected since they receive income from withholding taxes or their tax revenues are reduced by the tax credits used by taxpayers to eliminate double taxation.

**Subsidiarity**

This initiative is necessary since Member States tax cross-border activities according to their bilateral tax agreements, which are the result of bilateral negotiations. Each country pair arrives at a different solution. When there is no DTC applicable, withholding taxes are charged in accordance with unilateral rules decided in line with national tax policies. There is no spontaneous coordinated action to eliminate these obstacles to the internal market. Thus, action at EU level is required to guarantee harmonised and coordinated tax policies in this particular area of taxation.

The rationale for European action stems from the cross-border nature of the problem and the impossibility for each individual Member State to establish a single tax policy for itself and across the EU. Clearly, action at EU level will guarantee that Member States are bound by the exemption of withholding taxes to the same extent.

**Objectives**

The objective of this initiative is to reduce the above-described cross-border obstacles to the internal market by extending the scope of the withholding tax exemption provided by the Directive at the least possible cost. In particular, it is essential to eliminate the distortions due to the different regimes applicable to the capital flows of dividends, interest and royalties. Alignment of the Directive's scope with that of the Parent-Subsidiary Directive is thus one of

the main goals. This should promote financing and technological activities and reinforce the EU's specific policies in these areas.

**Policy options**

There is a range of policy options to be considered:

- Option 1: not taking any particular action.

- Option 2: the benefits of the Directive could be extended to payments between non-associated undertakings; in addition, the list of types of company to which the Directive applies could be broadened.

- Option 3: another solution would be to align the conditions of the Directive's benefits with those of the Parent-Subsidiary Directive, by considering that companies are associated when there is a direct or an indirect holding of 10 % and by extending the list of types of company to which the Directive applies.

- Option 4: the legal text of the Directive could be amended to clarify that payments by a permanent establishment related to its activities do enjoy the tax exemption.

- Option 5: a subject to tax requirement could be introduced that would rule out the withholding exemption when the recipient of the payment is not effectively subject to tax on the income derived from it.

Impacts of policy options

Option 1 would not address the economic costs and distortions resulting from withholding taxes and would not solve the problems described above.

Option 2 would affect Member States' tax revenues. Concerning interest payments, the 13 EU Member States that still apply withholding taxes to outgoing interest payments – Belgium, Bulgaria, the Czech Republic, Greece, Hungary, Ireland, Italy, Latvia, Poland, Portugal, Romania, Slovenia and United Kingdom - account for intra-EU interest payments that equalled almost €112 billion in 2008. Considering that only 10 % of the gross debt position in EU countries is between companies and that the average withholding rate in the countries that apply withholding tax to cross-border interest payments is 7.1 %, the gross revenue from withholding tax on inter-company payments works out at €0.8 billion. These lost revenues on outgoing interest would tend to be offset by gains from lower credits for withholding taxes paid in host countries. Hence netting for this effect would likely leave very limited net revenue effects: the loss should not exceed €200 to €300 million[3].

Concerning royalty payments, the total intra-EU outflow of royalties and licence fees was more than €31 billion in 2008. The 22 EU countries that apply withholding taxes to outgoing

[3] Source: Copenhagen Economics, *Taxation of interest and royalties — impact assessment of amendments to the present Directive,* October 2010.

royalty payments account for intra-EU royalty payments equal to €23.3 billion. The gross revenue from outgoing royalty payments considering an average withholding tax rate of 5.5 % is potentially around €1.3 billion for the EU as a whole. These lost revenues on outgoing royalties would tend to be offset by gains from lower credits for withholding taxes paid in host countries. Hence netting for this effect would likely leave very limited net revenue effects: for the seven countries with the largest negative royalty balances as a share of GDP - Bulgaria, the Czech Republic, Greece, Poland, Portugal, Romania and Slovakia - the loss should not exceed €100 to €200 million[4].

Currently, the scope of the Directive and the Parent-Subsidiary Directive is limited to associated companies. Extending the Directive's benefits to unrelated undertakings would be a new feature affecting the EU tax relations of all Member States.

For companies, the main effect of this second option would be to reduce compliance costs: up to approximately €126 million could be saved each year. The positive effect would be important for SMEs, for which these costs are proportionally higher. This type of company would also benefit from the elimination of withholding taxes on royalties: they tend to licence out their industrial property since they are not in a position to exploit their inventions themselves. On the other hand, disparities in taxation of dividends, interest and royalties would remain, with the corresponding distortions affecting intra-firm capital structure, the allocation of intellectual property of EU firms and the organisational form.

Option 3 would equalise the conditions provided for in the Directives on taxation of dividends, interest and royalties. It would contribute to the reduction of the above-mentioned tax distortions. In addition, it could produce benefits in terms of increased flexibility and lower restructuring costs in firms' choice of organisational form, capital structure, holding structures and allocation of intangibles. The savings in compliance costs for business could be estimated at between €38.4 and €58.8 million. The net revenue effects for the Member States would be even less than in the previous policy option; they could be roughly estimated at €160-€310 million. Transposing these changes into domestic law should not be particularly burdensome, since experience was gained with the implementation of the Parent-Subsidiary Directive.

In addition, there are two other initiatives that can be combined with options 2 or 3 in order to tackle two of the specific problems already described. Options 4 and 5 would surely help to make the Directive work better and should for this reason be included in any amending proposal.

The above estimates should, however, be taken with caution as they are based on a number of assumptions and statistical data, where legal considerations could not be made.

**Comparing the policy options**

As options 4 and 5 can be combined with options 2 and 3 we will refer in the following to two alternatives: alternative I would combine options 2, 4 and 5 and alternative II would combine options 3, 4 and 5.

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[4] Source: see footnote 3.

While alternative I would be more effective in reducing compliance costs, it would also be less efficient and inconsistent with other aims to improve the functioning of the Directive. In a context of unstable public finances, this solution would involve steeper reductions of Member States' tax revenues; implementation would be more difficult; and it would be inconsistent with the aim of eliminating the distortions deriving from the difference in scope between the Directive and the Parent-Subsidiary Directive.

Thus, alternative II is the preferred option since it offers a more balanced solution. It would not be as effective as alternative I in reducing compliance costs but it would still achieve all the objectives set by this initiative, with smaller tax revenue reductions. The public consultation launched by the Commission also shows that most of the stakeholders who responded preferred this alternative. On the other hand, the main option of alternative I, extending the Directive to payments between unrelated undertakings, received very little support, 29 % of the responses received.

The Member States also had an opportunity to express their views on these options at a meeting to discuss the Commission's report on the Directive held on 23 November 2009. In general, they were more inclined to accept initiatives on option 3; some of them rejected clearly any amendment on the basis of option 2. Concerning the technical modifications proposed in option 4, most of the Member States' delegates agreed on the need for a solution. Concerning option 5, the subject was brought up at the Ecofin Council meeting agreeing on the Directive, when there was a broad majority of Member States supporting Commission initiatives in this area. However, it should be stressed that the meeting of 23 November 2009 was of a technical nature and delegations were not asked to take a political position on the initiatives. In fact, a number of delegates remained silent during the debate.