

# Toward a unified EU system to avoid double taxation and prevent withholding tax fraud

By Eric CENTI, Tax Partner and Nenad ILIC, CFA, Tax Director, Deloitte Tax & Consulting

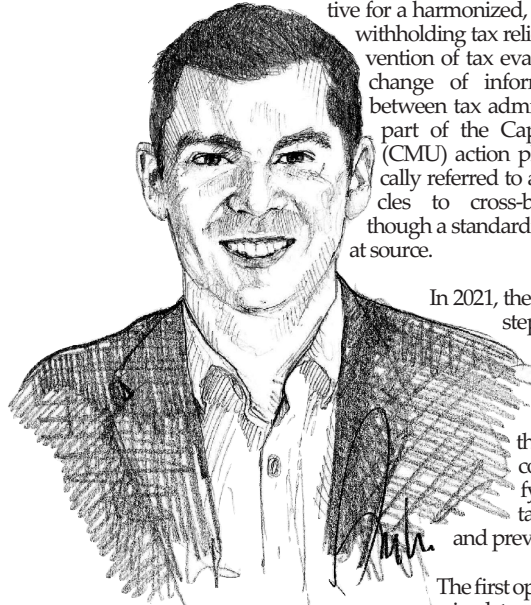
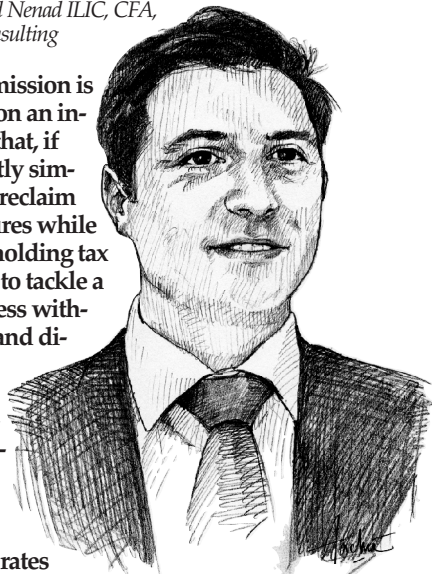
**T**he European Commission is currently working on an interesting initiative that, if adopted, could significantly simplify the withholding tax reclaim or relief at source procedures while reducing the risk of withholding tax fraud. The initiative aims to tackle a longstanding issue of excess withholding taxes on interest and dividends suffered by cross-border investors. While cross-border investors may be eligible for reduced withholding tax rates under double tax treaties, from a practical perspective such reduced rates are difficult to achieve due to overly complex procedures and lack of standardization at EU level.

## What is the issue?

When a cross-border investor makes an investment in securities in a member state, the dividends or interest he or she receives are normally subject to withholding tax in the country of the investment (i.e., source country). The withholding tax rate generally applied is the domestic rate which is often higher than the rate agreed by that source country in its double tax treaties. This means that an investor residing in a treaty country is often entitled to recover excess withholding tax by filing a reclaim with the source country's tax authorities.

The biggest challenge for investors willing to recover withholding tax stems from the fact that the tax forms, supporting documentation, languages, procedural requirements, and periods for submitting the claims are different for each source country. An investor holding shares of a German and a French company (and thus receiving German and French dividends) will need to file two completely different sets of documents with the German and French tax authorities, respectively. In addition, the technical criteria the investors must satisfy to be considered eligible for the reduced rates also differ. This means that investors often need to appoint tax professionals to help them navigate complexities and effectively exercise their right to recover excess withholding tax.

The EC estimated the total costs of withholding tax refund procedures at around €8.4 billion, which was mainly due to foregone tax relief, the costs of reclaim procedures as well as opportunity costs.<sup>(1)</sup> Even when reclaim procedures are followed to the letter, tax authorities often need several months, if not years, to process the claim and repay excess tax. Delays are



essentially caused by a lack of digitalization as most countries still require tax reclaims to be filed on paper.

To be fair, some countries do offer the possibility to apply relief "at source", in which case the reduced rates are applied upon income payment. The investors receive the correct amount of net dividends or interest, and they do not have to recover any excess tax *a posteriori*. While relief at source is certainly preferred to tax reclaims from an investor's perspective, the same challenges outlined above persist. To apply relief at source, investors still need to prepare complex paperwork which varies from one member state to another.

## European Commission's response and proposals

The issues outlined above are not new and have long been identified as a barrier to a well-functioning EU capital market. Already in 2001, it was observed<sup>(2)</sup> that although most of the Member States have bilateral treaties to avoid double taxation, there are no common procedures for claiming tax treaty benefits. In 2009, the European Commission (EC) acknowledged<sup>(3)</sup> that complex withholding tax procedures "hinder the functioning of the capital markets". And in 2017, the EC issued a *Code of Conduct on Withholding Tax*<sup>(4)</sup> in which it expressed concern that burdensome withholding tax procedures "increase the cost of cross-border trading and are a barrier to achieve a single European securities market." These non-binding recommendations called for voluntary commitments by member states to address the issues, unfortunately with little success.

In 2020, the EC took a more assertive approach by announcing legislative measures that would be binding for member states. First, as part of its Tax Package<sup>(5)</sup>, in which the EC announced that it will work on a direc-

tive for a harmonized, EU-wide system for withholding tax relief at source and prevention of tax evasion through an exchange of information mechanism between tax administrations. Then as part of the Capital Market Union (CMU) action plan<sup>(6)</sup>, which specifically referred to alleviating tax obstacles to cross-border investments through a standardized system for relief at source.

In 2021, the EC initiated the first step of the legislative process and issued an "inception impact assessment" which outlines the three main options it is considering for simplifying the withholding tax relief procedures and preventing tax fraud.

The first option refers to harmonized tax reclaim procedures enabling investors to reclaim withholding tax by filing standardized forms. Under this option, investors would still be subject to excess taxation and face potentially long repayment delays. However, they would be able to file standardized tax reclaim documents, potentially electronically, regardless of the member state the income is sourced from.

The second option refers to harmonized relief at source procedures that enable investors to submit a standardized set of documents, potentially electronically. Under this option, the reduced withholding tax rate would be applied when the income is paid, and investors would not need to subsequently file tax reclaims.

While the first two options aim at improving the existing tax reclaim and relief at source procedures without reinventing them, the third option constitutes a complete paradigm shift through new mechanism for the application of withholding taxes across the EU. This third option is strongly inspired by an OECD initiative called Treaty Relief and Compliance Enhancement (TRACE)<sup>(7)</sup> that was formalized in 2013 but never really lived up to its potential. (During its nine years of existence, only one country – Finland – actually implemented TRACE). Under this option, a financial institution through which the dividend or interest is paid would be able to become an "authorized intermediary" on behalf of member states' tax authorities.

In this way, the financial institution would be able to apply reduced withholding tax rates on income received by its clients and sourced from these member states. The reduced rates would be achieved "at source" with significantly less paperwork and in an almost automated fashion. The correct application of withholding tax rates and the prevention of tax fraud would be ensured through annual reporting by the

authorized intermediary to the tax authorities. Controls by independent third-party reviewers might also be required.

Referring to our previous example, any EU (and potentially non-EU) financial institution acting as an authorized intermediary would be able to withhold French or German withholding tax, a task that was generally reserved to French and German withholding agents only. An investor holding French and German securities on an account with that financial institution would be able to submit standardized tax documentation to the financial institution instead of filing claims with local tax authorities. The financial institution would apply the correct rates directly upon income payment and would no longer be required to forward its client's tax documentation to the French or German withholding agents or to file it with local tax authorities.

To collect feedback on these options, the EU launched a public consultation, ending in June 2022, that enabled close to 1,700 respondents to share their view on the most appropriate relief mechanism. Needless to say, the feedback received was overwhelmingly positive. Respondents generally welcomed the EC's proposals with a majority favoring harmonized relief at source procedures (including through the EU-wide implementation of TRACE) while acknowledging that harmonized tax reclaim procedures would still be required as a fall-back solution in case relief at source is not achievable.

## The way forward

This EU-wide harmonization of withholding tax procedures is more than 20 years in the making. Despite this, the formation of an EU directive looks more likely now than ever. The EC plans to adopt the directive by the end of 2022, which is very ambitious considering the complexity of the issue and the EC's myriad other initiatives. Investors and financial intermediaries alike are encouraged to monitor these developments and anticipate potential impacts in the coming months.

The one-off implementation costs and ongoing costs to ensure compliance with the new rules will be of particular importance to financial institutions that may become authorized intermediaries. Such costs should be weighed against long-term benefits associated with the reduced administrative burden, increased digitalization and improved client service. An objective cost-benefit analysis will be fundamental in deciding on the best course of action once the text of the directive is released.

1) COM (2017) 147 final

2) Cross-border clearing and settlement arrangements in the European Union, Economic Papers N°163, 2002

3) 2009/784/EC

4) Code of Conduct on Withholding Tax, European Union, 2017

5) COM (2020) 312 final

6) COM (2020) 590 final

7) TRACE implementation package for the adoption of the Authorised Intermediary System, OECD, 2013